



The income tax treatment of housing assets: an assessment of proposed reform arrangements

Inquiry into pathways to housing tax reform

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Acronyms and abbreviations used in this report

ABS	Australian Bureau of Statistics
AHURI	Australian Housing and Urban Research Institute Limited
AHURI-3M	Australian Housing Market Microsimulation Model
ALP	Australian Labor Party
ATO	Australian Taxation Office
CGT	Capital Gains Tax
EVITA	Evaluation of Income Taxes in Australia
Greens	The Australian Greens
HILDA	Household, Income and Labour Dynamics in Australia
IT	Taxation Ruling (Old Series: 1982 to 1992)
ITAA97	Income Tax Assessment Act (Cth) 1997
MITR	Marginal income tax rate
NILF	Not in the labour force
PBO	Parliamentary Budget Office
SIH	Survey of Income and Housing
TR	Taxation Ruling (Post 1992)

Glossary

A list of definitions for terms commonly used by AHURI is available on the AHURI website www.ahuri.edu.au/research/glossary.

Executive summary

- This report models several potential transitional arrangements that may ease the distribution pressures arising from reforms to negative gearing and capital gains tax (CGT) reform, and help smooth a reform pathway that is more politically acceptable.
 - Negative gearing and CGT discount benefits are currently heavily skewed towards those who are more affluent, raising concerns around the extent to which such policies exacerbate income and wealth inequality among the Australian population.
 - We model a progressive rental deduction reform whereby ‘mum and dad’ investors receive greater access to generous tax concessions than ‘sophisticated’ investors on higher income and wealth levels.
 - The progressive rental deduction reform cushions ‘mum and dad’ investors from significant drops in tax savings and will moderate adverse impacts on their economic wellbeing in comparison to a blunt cap on rental deductions.
 - A progressive rental deduction reform has the potential to reduce inequities in the current negative gearing system by reducing tax savings by proportionately greater amounts for those with higher income or property asset levels.
 - However, progressive rental deduction reforms are likely be administratively more complex to implement than a rental deduction cap. The former may also blunt incentives to work by investors.
 - A reduction in CGT discount will also have the potential to reduce inequities within the current system that favour higher income earners compared to lower income earners.
 - A gradual reduction in the CGT discount would ‘soften’ the impact of the CGT reform by providing a transition pathway that raises the after-tax economic cost of holding rental investment housing incrementally.
-

Key findings

How do existing elements of the Federal income tax system (in particular the availability of deductions and CGT provisions) potentially impact on housing ownership and affordability?

Currently, the Australian tax system offers preferential income tax treatment to both owner-occupied and own-to-invest properties. Owner-occupied properties are exempt from many taxes, including CGT. There is no imputed rent applied to claw back the exemption. In respect of own-to-invest properties, the report’s policy audit has shown that the income tax treatment of investment property provides an annual tax deduction to the owners of negatively geared property that subsidises the holding cost of property. This deduction is made up of a combination of cash outgoings, of which the most significant is loan interest, and capital

allowances that are non-cash expenses. In contrast, when the property is sold the gain is included on the capital account. The amount is included on realisation and is subject to a CGT discount of 50 per cent when derived by an individual or a trustee, or 33 per cent when derived by a superannuation fund.

Hence, the policy audit identified two key sources of asymmetric (or unbalanced) treatment of rental income and capital gains in the investment property market. First, there is a mismatch in the timing of the deduction and the capital gain, with the deductions predating the capital gain. Second, the amount of the rental deduction is not discounted, whereas the capital gain is discounted. This combination of factors provides an incentive for the owners of investment properties to borrow a larger proportion of the acquisition price. The incentive arises because the interest deduction is allowed in full whereas only 50 per cent of the capital gain is included. A leveraged investment will result in a higher capital gain where the growth in property prices exceeds the interest rate.

Which investor groups, household types and housing market segments benefit or are disadvantaged by current negative gearing and CGT provisions?

Negatively geared investors who receive the highest tax savings are typically middle-aged full-time employed males. On the other hand, the ones who benefit the least are females and older investors aged 55+ years who are not in the labour force. Home-owner investors who own both a family home and at least one rental investment property received the greatest CGT discount benefits, while renters who do not own properties do not receive any CGT discount. CGT discount benefits are heavily weighted towards those who are more affluent in terms of both income and property wealth. On average, a home-owner investor can own a property portfolio worth over \$730,000. Home-owner investors' average tax assessable income is \$82,000 compared to \$31,000 among renters who do not own any properties.

What are the revenue and distributional impacts of different negative gearing reform scenarios and transitional arrangements on housing investors and the Federal budget?

A complete abolition of negative gearing reforms has often been criticised by policy-makers for its potentially adverse impacts on the financial wellbeing of 'mum and dad' investors. Hence, in our first set of policy simulations, we distinguish between 'mum and dad' investors and 'sophisticated' investors who own higher levels of income or wealth, and we apply more generous concessions to the former. We differentiate between these investor groups in two ways—by applying income and property-based criteria.

Under the proposed reforms, 'mum and dad' investors in the bottom half of the income and property value distributions continue to receive a 100 per cent rental deduction and therefore experience no reduction in tax savings. At the other extreme, those in the upper quartile are subject to a full quarantine of negative gearing and therefore receive zero rental deductions, resulting in a complete loss of their tax savings from negative gearing. Those in the 50th to 75th percentiles receive an intermediate 50 per cent rental deduction. 'Mum and dad' investors in this group lose around half of their rental deductions and are therefore cushioned from a complete loss of their rental deductions. Hence, 'mum and dad' investors are less likely to make a behavioural decision to exit the rental market than if they were subject to a full quarantining of negative gearing, holding other factors constant. Such a measure therefore represents a potential transitional arrangement that could ease the pathway towards a complete negative gearing quarantine for all rental investors over time.

If a rental deduction cap is applied across all income levels, the average tax savings that negative-geared rental investors receive reduce only very slightly by \$25 under a generous \$40,000 cap to a \$921 decline if the cap is further reduced to \$5,000. Reducing the cap levels will result in increasingly lower levels of rental deductions across the income distribution.

Overall, the two reforms that will result in the greatest amount of budgetary savings are a rental deduction cap of \$5,000 and progressive rental deductions on an income-based criteria—both cost \$1.3 billion each, resulting in savings of over \$1.7 billion each. Both are progressive in nature, reducing tax savings from negative gearing by greater margins as tax assessable income increases.

What are the revenue and distributional impacts of different CGT reform scenarios and transitional arrangements on housing investors and the Federal budget?

It is possible to estimate the impact of a reduction in CGT discount rate on rental investors' economic outcomes in two ways. The first approach is to estimate the impact of the CGT reform on rental investors' after-tax or net incomes at the point of sale. The second is to estimate the impact of the reform on a rental investor's after-tax economic costs of holding rental property (per dollar of the capital value of their rental property) by amortising the investor's CGT liability across the investor's property holding period.

A reduction in CGT discount rate reduces the net incomes of rental investors. However, the extent of this reduction will depend on interactions across various factors, including the discount rate reduction, the investor's income and the investor's capital gains on the rental property at the time of sale. The greater the reduction in CGT discount rate and the higher the capital gains upon sale, the greater the reduction in net income. Holding other factors constant, a higher income investor will also experience a greater dollar reduction in net income at each reformed CGT discount rate than a lower income investor. However, in proportionate terms, the high-income investor experiences a smaller percentage reduction in net income.

A reduction in the CGT discount rate will impact on the after-tax economic costs of rental investors on higher incomes to a greater degree than investors on lower incomes. So for instance, among those in the 0.1–15 per cent MITR band in 2010, a reduction in CGT discount rate from 50 per cent to 0 per cent would raise their average user cost of capital from 7.3 per cent to 8.1 per cent, a rise of 0.8 percentage points. However, among investors in the highest MITR tax bracket, average user cost of capital would rise by 1.2 per cent—from 7.4 per cent to 8.6 per cent.

A gradual reduction in the discount would 'soften' the impact of the CGT reform. It provides a transition pathway that raises the after-tax economic costs of holding rental investment housing by 0.1 percentage point for every 10 percentage point reduction in the CGT discount rate. Assuming a rental investment property value of \$350,000, a 0.1 percentage point increase in user cost amounts to \$350 per year.

Policy development options

Negative gearing and CGT discount benefits are currently heavily skewed towards those who are more affluent, potentially exacerbating income and wealth inequality among the Australian population. In 2013–14, negatively-gearred rental investors made a loss of around \$8,800 on average while positively geared investors made a profit of around \$16,000. However, negatively-gearred investors have noticeably higher tax assessable incomes than positively-gearred investors. The former reported an average tax assessable income of \$91,000 in 2013–14 compared to \$78,500 among positively-gearred investors. Among negatively-gearred investors, those who receive the greatest tax savings also have the highest incomes and rental property values, and greatest net rental losses.

Similarly, CGT discount benefits are heavily weighted towards those who are more affluent in terms of both income and property wealth. On average, a home-owner investor owned a property portfolio worth over \$730,000 in 2013–14. Home-owner investors' average tax assessable income was \$82,000 compared to \$31,000 among renters who did not own any

properties. Hence, any reforms to negative gearing or CGT ought to ensure that it reduces inequities inherent within the current systems by reducing tax savings by proportionately greater amounts for those who have relatively high income or asset levels.

Negative gearing reform scenarios

A key policy concern is that a tightening of negative gearing parameters will impact ‘mum and dad’ investors’ economic wellbeing negatively and result in their mass withdrawal from the rental housing market. Hence, a progressive rental deduction that cushions ‘mum and dad’ investors from significant drops in tax savings will likely be a more appropriate policy option than a more blunt \$5,000 cap on rental deductions. The potential for significant housing supply contraction in the rental market may in turn be lower under a progressive rental deduction, holding other factors constant.

Moreover, an income (property value)-based deduction has the potential to reduce inequities inherent within the current systems. It does so by reducing tax savings by proportionately greater amounts for those who have relatively high income (property asset) levels than rental deduction caps.

However, progressive rental deduction reforms might be administratively more complex to implement than a cap. A more practical approach may be to differentiate between ‘mum and dad’ investors and ‘sophisticated’ investors by income or property value bands rather than percentile ranges.

Regardless of the income measure used to differentiate between the two types of investors, the nature of progressive rental deduction reforms may blunt incentives to work by investors looking to reduce their incomes so they fall into a band or percentile that allows them to be classified as ‘mum and dad’ investors.

Capital gains tax discount scenarios

A reduction in CGT discount rate would reduce the net incomes of rental investors. Holding other factors constant, a higher income investor will also experience a greater *dollar* reduction in net income at each reformed CGT discount rate than a lower income investor with the same capital gains rate. However, in *proportionate* terms, the high-income investor experiences a smaller percentage reduction in net income. Clearly, there is a discrepancy between percentage and dollar value impacts. Any CGT policy reform proposals would need to be carefully communicated to avoid a misconception that the impact of the CGT reform is likely to be regressive in terms of its proportionate impact on income.

A reduction in CGT discount will narrow the gap in user cost burdens that lower income and higher income rental investors have to bear, reducing inequities within the current system. This finding supports a case for a transitional approach in CGT reform. However, it is worth noting the pros and cons of adopting an approach of amortising CGT liabilities. While it represents a convenient and logical approach in the absence of necessary data on sales transactions and capital gains, it does not reflect the reality that the CGT is actually a lump sum liability rather than a recurrent expenditure.

The study

This study develops and models pathways to reform the income tax treatment of housing assets. It focuses on key tax arrangements that have featured prominently in national policy debates as having the potential to exacerbate distortions in property markets, including negative gearing arrangements and CGT provisions. The study is part of a wide AHURI Inquiry entitled *Pathways to Housing Tax Reform*.

The existing literature has highlighted concerns around the potentially distortionary effects of the present Federal income tax treatment of housing assets on housing market stability and housing affordability. Personal income tax concessions distort investment decisions, with adverse implications for the distribution of housing assets and outcomes in the housing market. First, the presence of debt-financed housing investors on a large scale is a potential source of instability in the housing market. Second, it would appear that property investors are increasingly crowding out first home buyers from the property market. Third, the asymmetric tax treatment of rental income and capital gains favour high tax bracket investors at the expense of low tax bracket investors. Fourth, the main residence exemption, under which a primary residence is exempt from capital gains tax, can reduce mobility of labour supply. In short, personal income tax concessions distort investment decisions, with adverse implications for the distribution of housing assets and outcomes in the housing market. Despite periodic national reviews of the tax system such as the 2010 *Australia's Future Tax System Review* ('Henry Review'), meaningful action aimed at implementing reform to the negative gearing and CGT provisions continue to be fraught with political obstacles to change. These policy concerns form the primary motivators behind this report.

The analysis is conducted in three related research phases. First, we present a detailed policy audit of Federal income taxes as they relate to property investment and ownership. Second, we analyse and validate the distribution of housing tax expenditures associated with existing income tax provisions on key housing groups across multiple nationally representative datasets—namely, the *Survey of Income and Housing* (SIH), *Household, Income and Labour Dynamics in Australia* (HILDA) Survey, and the Australian Taxation Office (ATO) sample file. Third, we simulate a range of alternative negative gearing and CGT discount scenarios to enable comparisons of the distributional and budgetary impacts of reformed and transitional arrangements.

For the policy simulations, we draw on two key pieces of microsimulation modelling infrastructure that have complementarities in capability—the Evaluation Model for Incomes and Taxes in Australia (EVITA) and the Australian Housing and Urban Research Institute Housing Market Microsimulation Model (AHURI-3M). EVITA and AHURI-3M are particularly well-suited to simulate the impacts of negative gearing and CGT reforms respectively, including transitional arrangements. The former is operationalised on the 2013–14 SIH and the latter on the 2010 HILDA Survey.

This report confirms an existing body of knowledge about the distortionary impacts of negative gearing and CGT discount arrangement, and the potential of policy reforms to alleviate these distortions, with potential benefits for stability and reduction in inequity in the treatment of different lower income subgroups versus higher income subgroups in the housing market. However, it also offers new findings that are both novel and which add to the policy evidence base.

First, a sample validation exercise conducted across three nationally representative datasets—the ABS SIH, HILDA Survey and ATO sample file—shows that there is a significant underestimation of the number of negatively geared rental investors and net rental losses in survey data. As part of this report's analysis, we have undertaken an intricate benchmarking exercise to redistribute net rental losses across rental investors in SIH, so that the distribution of net rental losses in the SIH are better aligned with the ATO data.

Second, this report has modelled several potential transitional arrangements that may ease the distribution pressures arising from reforms to negative gearing and CGT reform, and help smooth a reform pathway that is more politically acceptable. Importantly, a complete abolition of negative gearing reforms has often been criticised by policy-makers for its potentially adverse impacts on the financial wellbeing of 'mum and dad' investors. In a series of simulations, we distinguish between 'mum and dad' and 'sophisticated' investors and apply more generous

concessions to the former so that they are less likely to exit the rental market in response to a negative gearing reform that results in a reduction in rental deductions. Such a measure is therefore also a potential transitional arrangement that could ease the pathway towards a complete negative gearing quarantine for all rental investors over time.

1 Introduction

- This report develops and models pathways to reform the income tax treatment of housing assets focusing in particular on negative gearing and capital gains tax provisions.
 - The existing literature has highlighted concerns around the potentially distortionary effects of the present Federal income tax treatment of housing assets on housing market stability and housing affordability. Personal income tax concessions distort investment decisions, with adverse implications for the distribution of housing assets and outcomes in the housing market.
 - The presence of debt financed housing investors on a large scale is a potential source of instability in the housing market.
 - It would appear that property investors are increasingly crowding out first home buyers from the property market.
 - The asymmetric tax treatment of rental income and capital gains favour high tax bracket investors at the expense of low tax bracket investors.
 - The main residence exemption, under which a primary residence is exempt from capital gains tax, can reduce mobility of labour supply.
 - There are three related research phases:
 - a policy audit of Federal income taxes as they relate to property investment and ownership
 - analysis and validation of the distribution of housing tax expenditures associated with existing income tax provisions on key housing groups across multiple datasets
 - simulation of alternative reform scenarios to enable comparisons of the distributional and budgetary impacts of reformed and transitional arrangements.
-

1.1 Why this research was conducted

This report develops and models pathways to reform the income tax treatment of housing assets. It will focus on key tax arrangements that have featured prominently in national policy debates as having the potential to exacerbate distortions in property markets, including negative gearing arrangements and capital gains tax (CGT) provisions. In doing so, this project will inform the development of policies that seek to enhance the fairness and sustainability of the income tax treatment of housing in Australia.

The research project seeks to address four key research questions that shed light on the distributional and revenue consequences of current and potential Federal income tax parameters for individual (not institutional) investors:

- 1 How do existing elements of the Federal income tax system (in particular the availability of deductions and CGT provisions) potentially impact on housing ownership and affordability?
- 2 Which investor groups, household types and housing market segments benefit or are disadvantaged by current negative gearing and CGT provisions?

- 3 What are the revenue and distributional impacts of different negative gearing and CGT reform scenarios on housing investors and the Federal budget?
- 4 What potential transitional arrangements might minimise the revenue and distributional pressures during the process of reform?

1.2 Policy context

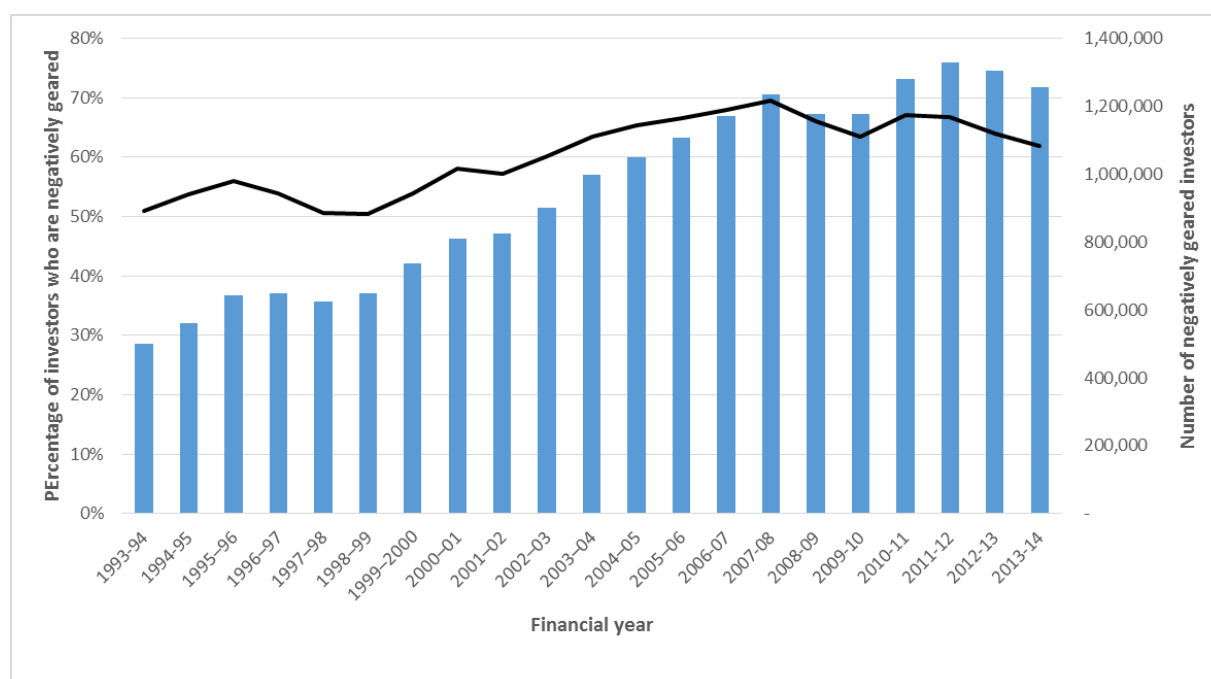
Under current income tax arrangements, the market supply of rental housing is dominated by private individuals, often characterised as ‘mum and dad’ investors. There is comparatively little institutional or corporate investment, as companies and investment funds receive few tax advantages from rental property investment compared to individual investors (Wood, Ong et al. 2010). This section provides a brief overview of the key Federal income tax provisions that affect individual landlords in order to clarify the policy context behind the project’s research questions. More details regarding the income tax treatment of housing assets are provided in Chapter 2’s policy audit.

1.2.1 Negative gearing

Negative gearing provisions can clearly generate tax shelter benefits for individual landlords. Investors can deduct from assessable income ongoing expenses pertaining to their rental property. If these expenses exceed gross rental income, the loss made on the rental property can be deducted from other sources of tax assessable income, resulting in what is commonly referred to as negatively gearing an investment property (Wood, Ong et al. 2011).

Indeed, the scale of negative gearing that occurs in the residential rental market is immense—estimates from the 2013–14 Australian Taxation Office (ATO) sample file show that there were over 1.2 million negatively geared property investors in that year, making up 63 per cent of all property investors. Indeed, Figure 1 below shows that both the share and number of negatively geared investors has been rising over the long-run. Between 1993–94 and 2013–14, the percentage of negatively geared investors rose from 50 per cent to 62 per cent, though it did peak during the housing market boom of the mid-2000s reaching about 70 per cent in 2006–07 before declining back to 63 per cent. Over the 20-year period, the number of negatively geared investors has more than doubled from 500,000 to over 1.2 million.

Figure 1: Percentage and number of property investors who are negative geared, 1993–94 to 2013–14



Source: ATO Taxation Statistics 1993–94 to 2013–14.

Tax concessions for outgoings on property exist in different forms across various countries. In a minority of countries tax concessions are available for mortgage interest on the taxpayer's residence, but this concession may be linked to imputed rent provisions, including the Netherlands and Switzerland; or restricted through other means, for example the USA caps the value of the loan (Andrews and Sanchez 2011; Yates 2010b).

In other countries, including Australia, a property must be producing income for an interest deduction to be allowed.

It would appear that Australia has some of the most generous negative gearing provisions within the OECD with few restrictions, along with Japan and New Zealand (Productivity Commission 2004). While the Federal government quarantined negative gearing provisions in 1985, this quarantining provision was repealed after just two years (O'Donnell 2005). On the other hand, some other countries have stricter negative gearing provisions. For instance, in the United States where a property is an income-producing property, rental losses are only claimable against rental income, as income from renting out a property is usually considered as passive income (Daley and Wood 2016; Wood, Stewart et al. 2010). In yet other countries, such as the Netherlands, a wealth tax is applied to investment properties, therefore negative gearing provisions do not exist (Productivity Commission 2004).

1.2.2 Capital gains tax concessions

While Australian home owners do not enjoy the benefits of negative gearing the family home, they do receive a full exemption from CGT when they sell the home. If a landlord sells an investment property, only 50 per cent of the capital gains are taxable at the landlord's marginal income tax rate (MITR).

The CGT was introduced with effect from 1985 by the *Income Tax Assessment Amendment (Capital Gains) Act 1986*. Until the Ralph review (1999), capital gains on investment properties were taxed at their real values at the property investor's MITR. Following the review, the CGT

system was reformed so that 50 per cent of capital gains would be taxed at nominal values. The motivation behind this reform was to encourage greater levels of property investment (Daley and Wood 2016).

In the 2016–17 year the foregone revenue from the CGT discount to individuals and trusts is estimated to be \$9,610 million (Treasury 2017). This is not segregated into assets classes, but it has been estimated that in 2013–14 nearly 40 per cent of capital gains received by individuals related to real estate (Daley and Wood 2016).

The combination of generous negative gearing provisions and the capital gains tax discount (CGT) has encouraged debt-financed property purchase by investors to chase speculative capital gains that are lightly taxed in comparison to ordinary sources of income (Wood, Ong et al. 2011).

Combined with negative gearing, individual investors are encouraged to debt finance their investment property to chase capital gains that are in turn lightly taxed upon sale, in comparison to taxable income from other sources.

1.2.3 Potential distortionary effects

The existing literature has highlighted concerns around the potentially distortionary effects of the present Federal income tax treatment of housing assets. These broadly relate to housing market stability and housing affordability concerns.

First, Cassells, Duncan et al. (2015) have highlighted that the share of investment property loans in total debt has tripled from one-tenth to three-tenths in approximately two decades. The presence of debt-financed housing investors on such a large scale is a potential source of instability in the housing market.

Second, investors now take up an increasingly greater share of the value of new loans compared to owner occupiers including first home buyers. Hence, it would appear that property investors are increasingly crowding out first home buyers from the property market (James, Rowley et al. 2015). Further, owner occupiers are able to access the main residence exemption on capital gains on the sale of their principal residence. This can distort the housing market by encouraging over investment in housing assets by established home owners (Kelly 2013).

Third, companies are taxed on all capital gains, like other income, at a flat rate of 30 per cent and superannuation funds that comply with Federal regulatory requirements are taxed at a rate of 15 per cent (and are only eligible for a 33.3% discount) on capital gains. These tax arrangements may deter institutional investment in rental housing as they make it more difficult for companies, property funds and financial institutions to obtain satisfactory returns on residential housing portfolios than ‘mum and dad’ investors. The lack of institutional investment can be a potentially significant factor contributing to the shortage of affordable rental housing (Wood, Ong et al. 2010).

Fourth, the asymmetric tax treatment of rental income and capital gains favour high tax bracket investors at the expense of low tax bracket investors. These market imperfections create rent clientele effects, whereby rental submarkets with high expected capital appreciation rates will attract high tax bracket investors because they pay lower taxes on capital gains than if they receive an equivalent sum in rental income. In contrast, in rental submarkets with low expected capital gains, high tax bracket investor demand will be weak, so property prices will fall. Low tax bracket investors will only invest in relatively low value rental housing that attracts rents that are high in relation to property values. This pushes up rents relative to property values in low value segments of the rental market, making rental housing more expensive and therefore less affordable in precisely those segments where lower income households typically seek housing (Wood and Tu 2004; Wood, Ong et al. 2010).

Fifth, the main residence exemption, under which a primary residence is exempt from capital gains tax, can also result in distortions in the housing market. It may influence the timing of the home-owner's decision to sell or retain a property, which may reduce mobility of labour supply; to improve the property to maximise tax free capital gains, or to sell in a rising market to realise a significant tax free capital gain.

In short, personal income tax concessions distort investment decisions, with adverse implications for the distribution of housing assets and outcomes in the housing market. Despite periodic national reviews of the tax system, such as the 2010 *Australia's Future Tax System Review* ('Henry' Review), meaningful action aimed at implementing reform to the negative gearing and CGT provisions continue to be fraught with political obstacles to change. These policy concerns form the primary motivators behind the research project.

1.3 Research methods

There are three related research phases:

- a policy audit of Federal income taxes as they relate to property investment and ownership, assessing the effect of existing policies on housing markets as well as potential income tax reform principles that could enhance the fairness and sustainability of the housing tax regime (Chapter 2)
- analysis and validation of the distribution of housing tax expenditures associated with existing income tax provisions on key housing groups across multiple datasets (Chapter 3)
- simulation of alternative reform scenarios based on different tax bases, rates and thresholds including comparisons of the distributional and budgetary impacts under current, reformed and transitional arrangements (Chapter 4).

1.3.1 Policy audit

The policy audit considers the provisions in the current tax system that have an impact on property ownership and investment. These include: capital gains tax (CGT) and the 50 per cent CGT discount for personal taxpayers, negative gearing and the main residence exemption. Capital works and decline in value provisions are also considered.

The policy audit is based on a review of specific provisions in the *Income Tax Assessment Act 1997* (Cth) (ITAA97) as well as Taxation Rulings, literature and secondary commentary concerning these provisions. The key policy changes relevant to this project included the implementation of the capital gains tax in 1985 and the introduction of the CGT discount in 1999. The audit included policy proposals published during the 2016 Federal Election and modelling and commentary evaluating those proposals.

1.3.2 Data analysis and validation

The report's overall empirical analysis relies strongly on the 2013–14 Australian Bureau of Statistics (ABS) *Survey of Income and Housing* (SIH), followed by the 2001–11 *Household, Income and Labour Dynamics in Australia* (HILDA) Survey.

The SIH is a cross-sectional survey that collects detailed information on household income and wealth, and housing outcomes. It also contains details on household and personal characteristics. Since 2003–04, the SIH has been conducted every two years. The SIH sample covers residents of private dwellings across urban and rural areas. The 2013–14 SIH sample included 14,162 households comprising 27,339 household members aged 15 years old and over (ABS 2015).

The HILDA survey is a nationally representative panel survey, which began in 2001 by interviewing 7,682 households comprising nearly 14,000 adult responding household members. These adult members were then re-interviewed in every subsequent year, to enable tracking of variations in their life circumstances, personal characteristics and experiences over time. This is done through a comprehensive range of variables on socio-demographic characteristics, household and income dynamics, housing outcomes, labour market outcomes, and measures of subjective wellbeing.

Both the SIH and HILDA Survey are initially benchmarked against data from the ATO sample files to assess the extent to which respondent reporting in the two surveys diverge from tax reporting to the ATO. The ATO sample file has been released every year from 2003–04. The sample files provide individual tax return information for a 1 per cent sample of records from 2003–04 to 2010–11, and 2 per cent sample from 2011–12 onwards.¹ It turns out that there are systematic biases in reporting in the survey data. Chapter 3 details steps that we have taken to minimise the impact of these biases on our results, particularly with respect to the 2013–14 SIH.

1.3.3 Modelling

The 2010 review of *Australia's Future Tax System* (the 'Henry' Review) notes the difficulties in assessing the overall impacts of Australian taxes and payments on housing market dynamics due to the 'complex ways in which tax-transfer policies interact with the housing market' (Henry, Harmer et al. 2010: Section 10). This report's methodology, which offers the capacity to link detailed income tax policy settings to housing market outcomes, is facilitated through microsimulation modelling, the results of which are presented in Chapter 4.

Microsimulation models are frequently employed by academics and policy-makers to predict the impacts of reforms to tax and transfer parameters on individuals, households and government budgets. The model is designed to simulate the parameters of the tax-transfer system under alternative policy scenarios for a sample of individuals. The outcomes of the simulations assist policy-makers with making decisions on whether or not particular policies ought to be implemented. This is because microsimulation modelling enables identification of winners and losers under alternative policy scenarios, and supports the analysis of distributional and budgetary impacts of potential policy reforms.

This report identifies proposed policy reforms through the policy audit in Chapter 2. A selection of these reforms are modelled using microsimulation modelling approaches in Chapter 4 that estimate first round impacts to accurately assess the household level implications of reforms as well as aggregate budgetary impacts. In particular, we draw on two key pieces of microsimulation modelling infrastructure that have complementarities in capability—with EVITA particularly well-suited to modelling the impacts of negative gearing and AHURI-3M the impacts of CGT reform, including transitional arrangements.

Evaluation Model for Incomes and Taxes in Australia (EVITA)

The Evaluation Model for Incomes and Taxes in Australia (EVITA) is a detailed income tax and transfer microsimulation model, developed by the Bankwest Curtin Economics Centre. EVITA provides a unique capacity to model both distributional and behavioural impacts of reforms to the full Australian tax and transfer system.

The model allows for the detailed investigation of the effects of policy changes to a wide variety of components in the transfer payment and income tax systems on individuals and households.

¹ See <https://data.gov.au/dataset/taxation-statistics-individual-sample-files> for further details.

Detailed changes and additions can be made to payment rates, income tests, assets tests, and/or rent assistance. The model currently runs on the 2013–14 SIH.

It turns out that reported net rental losses in the 2013–14 SIH under-represent the reported net rental losses by taxpayers to the ATO as does the HILDA Survey (see Chapter 3 for more details). The EVITA model has been designed to alleviate the bias in net rental loss estimates in the 2013–14 SIH through a net rental income redistribution module, so it is uniquely well-suited to simulate the impacts of negative gearing policy reforms with a high degree of accuracy. However, due to the cross-sectional nature of the SIH, it is not possible to observe the capital gain of properties that, when sold, would in turn attract a CGT discount. Hence, the EVITA model is more limited with respect to its capability to simulate the impacts of CGT reform.

These new methodological developments substantially improve our capacity to model the distributional impacts of negative gearing reforms. However, it is important also to note the limitations of microsimulation methods in housing tax policy analysis.

Behavioural tax microsimulation is well suited to capture employment responses to tax and welfare reforms. However, there are far more complexities in modelling the behavioural impacts of housing tax policy reforms. This is a function of i) the breadth of agents involved in housing choices—renters, owners, investors, the housing industry, governments; ii) the complexity of decisions related to housing choice—many of which take place in a life-cycle context; iii) the complexity of the housing market itself; and iv) the scale and significance of many housing tax policy instruments.

In consequence, the behavioural effects of negative gearing policies on housing supply; housing market entry, duration and exit; and housing price, are beyond the scope of this AHURI-funded project. Nevertheless, this limitation does highlight the pressing need for a major modelling initiative to capture housing market dynamics, including the influence of housing tax policies.

Australian Housing and Urban Research Institute Housing Market Microsimulation Model (AHURI-3M)

AHURI-3M is an Australian housing market microsimulation model. It is benchmarked on the 2001–11 HILDA Survey. It contains detailed tax, benefit and housing assistance parameters for every year over the period 2001–11. It was recently used to estimate the magnitude and distribution of housing subsidies as part of the Henry Review of the Australian Tax System (Wood, Stewart et al. 2010). The microsimulation model has also been used to estimate the magnitude and distribution of negative gearing (Wood, Ong et al. 2011), low-income housing tax credits—a forerunner of NRAS in the USA (Wood, Watson et al. 2006), as well as the role of tax subsidies in driving tenure choice (Hendershott, Ong et al. 2009) and the supply of rental housing (Wood and Ong 2013). It has therefore established itself as an important tool for the distributional analysis of the tax treatment of housing assets.

As noted above, it is not possible to observe the sale of properties by rental investors that would in turn attract a CGT discount in the SIH. Because the sale of a property that attracts a CGT is a one-off transaction rather than a recurrent transaction, an alternative approach of measuring the impact of CGT (and CGT reforms) on rental investors' economic outcomes is to amortise capital gains tax liabilities across the investor's holding period (Wood and Ong 2010; Wood, Ong et al. 2011; Wood and Ong 2013). AHURI-3M contains a rental investors module operationalised on three of HILDA's wealth modules—in 2002, 2006 and 2010—that specifically measure the after-tax economic cost of supply rental housing borne by rental investors, also commonly known as 'the user cost of capital'. It is usually measured per dollar of capital value. The key components of the user cost typically comprise recurrent and capital components, with the latter amortised

over a holding period of 10 years. The recurrent components include annual financing costs,² annual operating costs³ and annual capital gains, while the amortised capital components include the amortised value of CGT liability and transaction costs. Details on measurement of the key components of the user cost are laid out in Wood and Ong (2008). Hence, it is exceptionally well-suited for modelling the impacts of CGT reform, though less so for negative gearing reforms due to the under-reporting of net rental losses in the HILDA Survey.

² The financing costs include after-tax interest on mortgage debt and the after-tax return sacrificed on the rental investor's equity stake in the property.

³ Operating costs include maintenance costs, property taxes and land taxes.

2 Income taxes and affordability: an audit of current policies

- The Australian tax system is asymmetrical in respect of both owner-occupied and own-to-invest properties.
 - Owner-occupied properties are exempt from many taxes, including capital gains tax. There is no imputed rent applied to claw back the exemption.
 - In respect of own-to-invest properties, it allows a deduction on revenue account for the ongoing costs of holding a rental property, while only including a reduced amount of income from the sale of that property. This asymmetry encourages borrowing to invest in property from rent, as the cost of finance is subsidised, and the amount of capital gain after repaying borrowed funds is magnified, even after repaying borrowed funds.
 - The highest categories of expenses that are claimed by landlords include mortgage interest, capital works and depreciation deductions, all of which are arguably related to the capital value of the property—and may in fact be included in the cost base for CGT purposes if not previously claimed. Although depreciation deductions are clawed back on sale of the property, other deductions claimed while the property is rented are not accounted for in calculating the capital gain.
-

This chapter addresses the following research question:

How do existing elements of the Federal income tax system (in particular the availability of deductions and CGT provisions) potentially impact on housing ownership and affordability?

2.1 What we already know about the effect of the income tax system

Existing research has identified the asymmetrical nature of negative gearing, which is on the revenue account, and the subsequent gain on the sale of property, which is on the capital account. The most significant tax benefit arises from the discounted nature of capital gains tax, which was introduced in 1999.

In order to address the research question that is the subject of this chapter, a policy audit has been undertaken of the relevant income tax provisions that underpin the housing market in relation to owner-occupiers and investors.

There are several features of the Australian tax system that have an impact on taxpayers' decisions concerning housing and, in turn, the housing market. These include the main residence exemption from capital gains tax (CGT), which is restricted to owner-occupied housing; and the 50 per cent CGT discount for individuals, negative gearing and capital works write-offs that are available to a range of capital investments including housing investments.

Tenants who rent housing do not receive any preferential tax treatment directly, although it is possible that some of the tax preferences received by landlords are passed indirectly to renters in the form of reduced rents in comparison to those that would apply absent the tax preferences.

Wood and Ong (2010: 5) described tax preferences as 'a pervasive influence in housing markets'. They noted that investors in a high income tax bracket benefit more from negative gearing. Berry and Dalton (2004) noted that differential impacts of CGT, income tax and GST regimes exert complex distributional and efficiency effects on housing markets.

2.2 The income tax treatment of capital gains

2.2.1 Owning to occupy

The main residence exemption in subdivision 118-B of the ITAA97 narrows the overall tax base and results in an effective tax rate of zero on owner-occupied housing. Internationally there are a range of tax expenditures available to owner occupiers, including:

- deductibility of mortgage interest, with few of those countries imputing a rent against the mortgage interest (Andrews and Sanchez 2011)
- full exemption from capital gains tax, for example Canada
- or
- partial exemption from CGT for a taxpayer's main residence; for example, currently the principal residence exemption in the USA is \$US250,000 for singles and \$US500,000 for couples (US Internal Revenue Code § 121).

The main residence exemption constitutes the largest tax expenditure (Treasury 2017). The two components of the main residence exemption are estimated to cost \$54,500 million in 2015–16. Other consequences of the main residence exemption include:

- too much capital being invested in housing and not enough in other assets (Burman and White 2010)
- the main residence exemption is of greater value to high-income taxpayers and, therefore, vertically inequitable (Cooper and Evans 2014)
- it is not tenure-neutral, resulting in differences in the treatment of owner-occupied and rental housing (Yates 2010a)
- incomes of homeowners are increased by the value of the shelter and other services they receive from their owner-occupied housing (Ozanne 2012).

The imputation of rent notionally attributes income against housing tax concessions, introducing neutrality between owner-occupied and investor housing. Irrespective of its merits or otherwise, it is highly unlikely that the taxation of imputed rent will be reintroduced in Australia.

2.2.2 Owning to invest: capital gains tax discount

The taxation treatment of capital gains held by an individual or a trustee depends on the date of acquisition and the CGT event resulting in the disposal of the asset.

- The gain on assets acquired before 20 September 1985 are exempt.
- The gain on assets held for less than 12 months are taxed in full.
- Assets acquired before 21 September 1999 but sold after that date may be taxed on the basis of an inflation indexed gain (Div 114 ITAA 97).
- Assets acquired and sold after 21 September 1999 are eligible for a discount of 50 per cent on the gain on sale (Div 115 ITAA 97).

The former Howard Government introduced the 50 per cent CGT discount on the recommendation of the 1999 Ralph Review of Business Taxation (Ralph 1999), which

recommended the introduction of the discount 'to enliven and invigorate the Australian equities markets, to stimulate greater participation by individuals, and to achieve a better allocation of the nation's capital resources' (Ralph 1999: 598).

The capital gains tax discount for individuals and trusts is a significant tax expenditure, estimated at \$6.84 billion in 2016–17.

The CGT discount is a tax expenditure that is inequitable in its distributional impact. It is counter to the traditional tax policy principles of horizontal and vertical equity and it can create incentives for economically inefficient tax sheltering whereby ordinary income is re-characterised as capital.

Concerns about vertical equity, related to CGT rate preferences, arise from the fact that most of the benefits of CGT rate preferences are derived by taxpayers with high taxable incomes, since most capital gains are accrued and realised by this taxpayer demographic. Therefore, a CGT rate preference such as the CGT discount would generally result in a vertically inequitable tax system, since the benefits of the preference are concentrated at higher levels of income, given the skewed way in which capital gains are distributed.

CGT rate preferences, such as the CGT discount, may also lead to horizontal inequity since there is an unequal distribution of the tax burden among those taxpayers with the same taxable income, but who have differing proportions of capital gains to total taxable income, although Shaviro (1992–93), argues that horizontal equity is not necessarily a criterion against which CGT should be evaluated.

The *Review of Australia's Future Tax System* ('Henry' Review) recommended a 'savings income discount' of 40 per cent for capital gains and other returns on investment including net rental income (Henry, Harmer et al. 2010, Recommendation 14: 83). The Henry Review noted that extending the discount rate to net rental income would result in a more neutral treatment of investment in housing and generally better outcomes for taxpayers who are not as reliant on debt-financed investment in housing. According to the Henry Review, 'the tax system is unlikely to be an effective instrument to move housing prices toward a particular desired level and the tax system is not the appropriate tool for addressing the impact of other policies on housing affordability' (Henry, Harmer et al. 2010: 420).

Brown, Brown et al. (2011) estimated the user cost of housing. Based on the findings in their study, Brown, Brown et al. commented on the 50 per cent CGT discount, negative gearing and the principal residence CGT exemption (which they characterised as a 100% CGT discount). They argued that negative gearing provisions may be less distortive than the CGT concessions. Specifically, it is their conclusion that although the negative gearing provisions provide for similar treatment of housing and other forms of investment, the CGT discount and principal residence exemption provide for differential treatment compared to capital gains held for less than 12 months.

2.3 The income tax treatment of rental expenses

2.3.1 Negative gearing

As explained in section 1.2.1, negative gearing is a term that is used to refer to a scenario where the owner or owners of a rental property claim income tax deductions that exceed the revenue received from that property.

Negative gearing, per se, is not a tax expenditure. A tax expenditure 'arises where the actual tax treatment of an activity or class of taxpayer differs from the benchmark tax treatment' (Treasury 2017). Other than to the extent that the expenses claimed include capital works deductions, negative gearing results from the normal operation of the Income Tax Assessment Acts.

In a paper that examined negative gearing in first- and second-best scenarios, Fane and Richardson (2004: 220) concluded that negative gearing is 'something that would be allowed in a system that taxed real income, properly measured'. They also concluded that the tax treatment of capital gains is a major loophole in a scenario where house prices increase rapidly.

Taxation Statistics (ATO 2017: 3) show that in relation to individuals, in the 2013–14 year 2,842,139 rental schedules were lodged. Of these, some 60 per cent claimed losses. The mean loss amount claimed was \$6,700; and the mean profit amount was \$6,928.

Hulse and Burke (2015) noted that some organisations that represent property owners have argued that negative gearing may meet increased demand for private rental property and that it may increase supply and, in turn, moderate rental costs.

According to Hulse, Burke et al. (2012: 17), negative gearing was a 'relatively little known and used tax provision' to the point that it may have been considered 'invisible in the early 1980s'. They argue that an increased proportion of investors in housing became aware of negative gearing due to the reversal of the quarantining rules by the then Labor government in 1987.

Hulse, Burke et al. (2012) argued that negative gearing may increase demand pressures and the inflation of housing prices to the extent that most investment to which negative gearing applies is in existing housing stock rather than in newly constructed dwellings.

Warren (2003) noted that although the tax-preferred status of residential housing 'must be addressed', there would be negative consequences associated with removing all concessions on housing, one of these being that their capitalised value would 'come off property prices almost immediately'.

The highest categories of rental expenses claimed by landlords; and the expenses most likely to be claimed by landlords reporting a loss are interest expenditure, depreciation and capital works claims.

2.3.2 Interest deductions

A rental investor can earn a higher rate of return on their investment by leveraging their initial investment, even without the benefit of annual tax losses.

Since 1967 the ATO has determined that interest charges are deductible where the amount payable exceeded the expected income (ATO 1967).

In order to be deductible under s.8–1 of ITAA 97:

- TR 2000/2 requires that there must be a direct nexus between the expense and the income: the borrowed money must have been applied to earn the assessable income: the 'use test' (ATO 2000).
- IT 2167 states that the deduction may be only partly allowed where there is clearly a purpose other than the derivation of assessable income, but that it will depend on the circumstances of each case, and must be determined objectively (ATO 1985).
- TR 95/33 addresses the issue of negative gearing as follows:

Negatively gearing the acquisition of an income producing asset will require a consideration of all the circumstances of the case in order to decide how much, if any, of the interest expense is deductible under subsection 51(1). In the commonly encountered kinds of circumstances where assets are negatively geared, a common sense or practical weighing of all the factors surrounding the acquisition could be expected to lead to the conclusion that the relevant interest expense is properly to be characterised as genuinely, and not colourably, incurred in gaining or producing the assessable income and will fall entirely within either the first or second limb of subsection 51(1) (ATO 1995 at paragraph 16).

In reviewing interest deductions from negatively-gearred rental property from a tax policy perspective, O'Donnell (2005: 103) concluded that negative gearing had increased income inequality and had led to 'a disproportionately high level of housing finance invested in rental properties'. O'Donnell recommended that interest deductions from negatively geared housing be quarantined on an 'asset by asset' basis, with a carry forward of losses to be offset against future income and capital gains from the same asset. It was also noted by O'Donnell that the argument that negative gearing may cause lower rents due to an increased supply of rental properties and lower costs for landlords was one which was based on false assumptions.

2.3.3 Capital works

Most relevant capital expenditure falls for consideration under either Division 40 ITAA97 in respect of depreciating assets that reduce in value over time, or Division 43 ITAA97 for capital works. Under the capital works provisions, the cost of certain buildings and related expenditure can be deducted over either 25 or 40 years as long as the property is used for income producing purposes.

Many residential rental properties are not eligible for the capital works deduction. No tax deduction was available for capital works completed prior to 1979, and capital works in relation to rental properties are not deductible on buildings completed prior to 1985.

The effective life of capital works is generally longer than the 25 or 40 years over which the capital works are deducted. Accordingly the capital works deduction is reported as a tax expenditure which is estimated to cost \$1,000 million in the 2015–16 year; and to increase by an additional \$35 million in each of the following years included in the estimates (Treasury 2017).

2.3.4 Depreciation

A fixture to property that is not classified as capital works is likely to be considered as a depreciating asset. A depreciating asset is defined in s.40–30 ITAA97 as an asset that has a limited effective life and can reasonably be expected to decline in value over the period it is used, but it specifically excludes land. Accordingly a fixture to land will not be a depreciating asset.

Depreciation is not classified as a tax expenditure unless the deduction is accelerated under a specific measure. The tax expenditure benchmark for depreciation deductions is that the plant is depreciated over the effective life of the asset. However, timing issues can arise as the deduction claimed each year may not equal the actual reduction in the value of the asset, and the difference is adjusted on disposal by way of a balancing charge.

The 2017–18 Budget includes proposals to restrict deductions for depreciating assets that are acquired with an investment property, however these proposals are not yet law.

2.4 Interaction between negative gearing and capital gains tax

The most significant income tax measures relevant to investment in housing are CGT and negative gearing, and the relationship between the two.

The interaction of the capital gains discount with negative gearing results in a timing mismatch; deductions are claimed on an annual basis, and allowed against income from other sources, whereas the capital gain is taxed at a later point in time, when the gain on the sale is realised. This is further compounded by the availability of the CGT discount.

The mismatch between income and deductions for rental property was identified prior to the enactment of capital gains tax (Krever 1985), and was one of the reasons for the introduction of the capital gains tax in 1985. Specifically, prior to September 1985 capital gains were not

subject to tax. Clearly, in the case of rental property investment part of the investor's return is in the form of capital gains. Therefore at that time, there was a case for denying rental property deductions to the extent that the expenses had been incurred in earning capital gains. The introduction of the capital gains tax in 1985 addressed this asymmetry, but the concessional tax treatment of capital gains since September 1999, by way of the CGT discount, has arguably restored the 'loophole' referred to by Krever.

The 50 per cent CGT discount has a distorting effect on investment decisions as it creates a tax advantage for assets where most of the return is in the form of capital gains in comparison to assets which have a greater part of their return in the form of income. Housing is clearly an asset type which is in the former category. In aggregate in 2013–14 taxpayers claimed tax losses from rental property investments. That is, the net income return from rental property for the entire taxpayer population was negative. The aggregate taxpayer population reporting net rental losses has occurred in almost all income tax years during which the 50 per cent CGT discount has been in operation. There were several income tax years prior to 1999–2000, when the CGT discount was enacted, in which there was net income from rental property for the aggregate individual taxpayer population.

Grudnoff (2015) estimated that the benefits of the CGT discount and negative gearing are highly skewed in favour of high-income taxpayers. Wood and Ong (2010) noted that there is a larger tax shelter benefit of negative gearing for taxpayers in higher tax brackets.

Wood, Ong et al. (2016) noted that tax preferences used by investors can contribute to distortions in the supply of private rental housing. Specifically, taxpayers in the top marginal tax rate bracket benefit more from negative gearing and the CGT discount compared to taxpayers in other tax rate brackets and, consequently, they can supply rental housing at a lower cost (Wood, Ong et al. 2016).

2.5 International comparison

Internationally, owner occupiers obtain a range of tax concessions. Yates (2010b: 42) sets out the tax treatment of deductions that can be claimed by investors as follows:

Table 1: International comparison of tax regimes (investors)

Country	Interest Deduction	Negative Gearing	Capital Works	CGT	Land Tax
Australia	Yes	Yes	Yes, if built after 1985	50 per cent	Yes
Canada	Yes	Limited to cash outlays	Yes: Recouped on sale	50 per cent	Yes
France	Yes	Capped + Interest cannot > gross rent	Yes	Exempt if held > 15 years	Limited
Germany	No	Yes	Yes	Exempt if held > 10 years	Limited
Netherlands	Wealth tax levied based on assumed rate of return				Yes
New Zealand	Yes	Yes	Yes	No	Limited
Sweden	Yes	Yes	No	Limited	Yes
Switzerland	Yes	No	Outlays	Yes	Yes
UK	Phasing out by 2020–21	No	No	Yes	Yes

Country	Interest Deduction	Negative Gearing	Capital Works	CGT	Land Tax
US	Yes	Not allowed against labour income	Yes	Yes	yes

Source: Yates 2010b.

Daley and Wood (2016) noted that Australia's treatment of rental property losses is generous given that comparable countries, including the United States and the United Kingdom, impose limitations that disallow rental losses being offset against labour income. They recommended a reduction in the magnitude of the CGT discount from 50 per cent to 25 per cent and quarantining rules that would prevent taxpayers from offsetting rental property losses against labour income.

2.6 Policy implications of the research

The policy audit has shown that the income tax treatment of investment property provides an annual tax deduction to the owners of negatively geared property that subsidises the holding cost of property. This deduction is made up of a combination of cash outgoings, of which the most significant is loan interest, and capital allowances which are non-cash expenses.

In contrast, when the property is sold the gain is included on the capital account. The amount is included on realisation and is subject to a discount of 50 per cent when derived by an individual or a trustee, or 33 per cent when derived by a superannuation fund.

The policy audit identified:

- a mismatch in the timing of the deduction and the capital gain with the deductions predating the capital gain
- the amount of the rental deduction is not discounted whereas the capital gain is discounted.

This combination of factors provides an incentive for the owners of investment properties to borrow a larger proportion of the acquisition price as the interest deduction is allowed in full whereas only 50 per cent of the capital gain is included. A leveraged investment will result in a higher capital gain where the growth in property prices exceeds the interest rate.

3 Negative gearing and capital gains tax: a distributional analysis

A sample validation exercise is conducted across three nationally representative datasets, the ABS SIH, HILDA Survey and ATO sample file. The total number of rental investors are similar across the three datasets at around 2 million. However, while nearly 61 per cent of rental investors in the ATO data reported a net rental loss in 2013–14, much lower proportions have negatively geared status in SIH and HILDA.

We conduct an intricate benchmarking exercise to redistribute net rental losses across rental investors in SIH, so that the distribution of net rental losses in the SIH are better aligned with the ATO data.

The typical negatively-geared investor is male, aged in his mid-to-late forties, and employed full-time. On the other hand, positively-geared investors tend to be evenly split between males and females and more likely to be older and retired.

Negatively-geared investors have higher tax assessable incomes than positively-geared investors.

Rental investment spells that start off being negatively geared are more likely to be terminated after 5 years than those that start as positively geared.

Among negatively-geared investors, those who receive the greatest tax savings are also those who have the highest incomes and rental property values, and greatest annual net rental losses.

Home-owner investors who own both a family home and at least one rental investment property received the greatest CGT discount benefits, while renters who do not own properties do not receive any CGT discount.

CGT discount benefits are heavily weighted towards those who are more affluent in terms of both income and property wealth. On average, a home-owner investor can own a property portfolio worth over \$730,000. Home-owner investors' average tax assessable income is \$82,000 compared to \$31,000 among renters who do not own any properties.

This chapter addresses the report's second research question:

Which investor groups, household types and housing market segments benefit or are disadvantaged by current negative gearing and CGT provisions?

We begin with a data validation exercise by comparing the 2013–14 SIH and 2013–14 HILDA Survey with the 2013–14 ATO 2 per cent sample file. While both SIH and HILDA are nationally representative surveys, the data validation exercise is conducted to ensure that respondents reporting in the two surveys do not diverge significantly from tax reporting to the ATO.

Surprisingly, it turns out that the net rental income data in the surveys do diverge systemically from ATO net rental income data. However, the policy simulations in Chapter 4 rely on the use

of SIH. Hence, we conduct an intricate ‘redistribution of net rental losses in the SIH data to better align the reporting of net rental income in SIH with the ATO data. This exercise is an innovation offered by the report; to our knowledge it has not been attempted in previous Australian empirical work on negative gearing.

Following the data validation exercise, we offer a detailed distributional analysis to shed light on the extent to which different population subgroups benefit from or are disadvantaged by current negative gearing and CGT provisions. This is done firstly using the cross-sectional 2013–14 SIH, and complemented by some panel data analysis using the longitudinal HILDA Survey.

3.1 Data validation—SIH, HILDA and ATO

3.1.1 Rental investors

We begin by aligning the definition of rental investors across the three datasets to ensure that they are as consistent with ATO definitions as possible. While the SIH distinguishes between rental investors who own resident and non-residential property, the HILDA Survey and ATO do not. To maintain consistency with these other key data sources, we include individuals who own both types of property. In any case, a comparison of residential and non-residential rental investors from the SIH show that the latter are a minority, forming around 4 per cent of all rental investors in Australia. Hence, in this report rental investors are defined as individuals who currently receive rental income from residential and non-residential rental property.

All three data sources contain population weights that allow population estimates to be derived from the data. Weighted results from the surveys produce rental investor population numbers that are fairly consistent, these being 1.77 million in SIH, 1.84 million in HILDA, and 2.03 million in the ATO sample file.

3.1.2 Share of positively-gearred, negatively-gearred and break-even rental investors

We rely on annualised current weekly rental income in our analysis that draw on the 2013–14 SIH.⁴ In the HILDA Survey and ATO data, rental income is reported on a financial year basis only.

Net rental income can be either:

- positive (when gross rental income exceeds expenses)
- negative (when expenses exceed gross rental income)

or

- nil (when the rental investor breaks even).

Hence, in all three datasets, it is possible to identify and classify rental investors into:

- positively-gearred (when net rental income is positive)
- negative-gearred (when net rental income is negative)
- break-even (when net rental income is nil).

⁴ While it is also possible to observe net rental income in the SIH on a financial year basis, we have opted to rely on annualised currently weekly income so as to reflect the most current estimates available at the time of the analysis. Annualised current weekly income in the 2013–14 SIH relate to the year 2013–14, while financial year income data in the 2013–14 SIH relate to the year 2012–13.

Table 2 below compares the distribution of positively-gearred, negatively-gearred and break-even landlords across the three data sources for the year 2013–14, and reveals some very interesting differences. While the total number of rental investors are similar across the three datasets (between 1.7 and 2 million), the distribution of the three categories of rental investors differs widely between the ATO and the two surveys.

Focusing on population weighted estimates, we find that nearly 61 per cent of rental investors reported a net rental loss in 2013–14. Hence, according to the ATO data, the number of negatively-gearred investors clearly outweigh the number of positively-gearred and break-even landlords. On the other hand, in both the SIH and HILDA Surveys, the patterns are very different. In the SIH (HILDA Survey), around 48 per cent (35%) of rental investors reported that they were negatively geared in 2013–14. Hence, the number and share of negatively-gearred rental investors are much lower in the SIH and HILDA Surveys than in the ATO data.

Another worrying difference is that 17 per cent of rental investors in the SIH reported break-even status, and 11 per cent do so in the HILDA Survey. In contrast, no rental investor reported break-even status in the ATO data.

However, an investigation of the survey questions that underpin the SIH and HILDA net rental income variable offers no further details on why there is an under-representation of negatively-gearred rental investors in the SIH and HILDA surveys relative to the ATO data. In the SIH and HILDA surveys, rental investors are not required to detail the kinds of expenditure items they have taken into account to calculate their net rental income. A conjecture is that rental investors who report that they break even are not taking into account non-cash expenses, for example depreciation. This implies a potential measurement error issue with respect to rental income in SIH and HILDA. This is a data limitation and we embark on an intricate benchmarking exercise between the SIH and ATO data. This exercise is designed to redistribute net rental losses across rental investors in SIH, so that both the distribution of net rental losses and sum of net rental losses in the SIH are better aligned with the ATO data.

Given the intricate and time-consuming nature of this exercise, we focus on the redistribution of net rental losses in the SIH and note for now that an important future research direction is to implement the same exercise for all waves of the HILDA Survey. Currently, 15 waves of the HILDA Survey are potentially afflicted by an under-reporting of net rental loss.

Table 2: Number and distribution of rental investors, 2013–14, per cent by column

	SIH		HILDA		ATO	
	Number	Per cent	Number	Per cent	Number	Per cent
<i>Sample</i>						
Profit	989	35.4%	1,019	54.3%	15,633	39.0%
Loss	1,289	46.2%	648	34.5%	24,391	60.9%
Break-even	514	18.2%	209	11.1%	50	0.1%
Total	2,792	100.0%	1,876	100.0%	40,074	100.0%
<i>Population</i>						
Profit	627,579	35.5%	1,003,213	54.6%	781,650	39.0%
Loss	839,870	47.5%	633,091	34.5%	1,219,550	60.9%
Break-even	301,870	17.1%	201,318	11.0%	2,500	0.1%
Total	1,769,318	100.0	1,837,622	100.0	2,003,700	100.0%

Note: Due to the absence of weights in the ATO sample file, each respondent in the sample is given a weight of 50 to derive population estimates as the sample file is drawn from 2 per cent of the population.

Source: 2013–14 SIH, 2013 HILDA Survey and 2013–14 ATO 2 per cent sample file

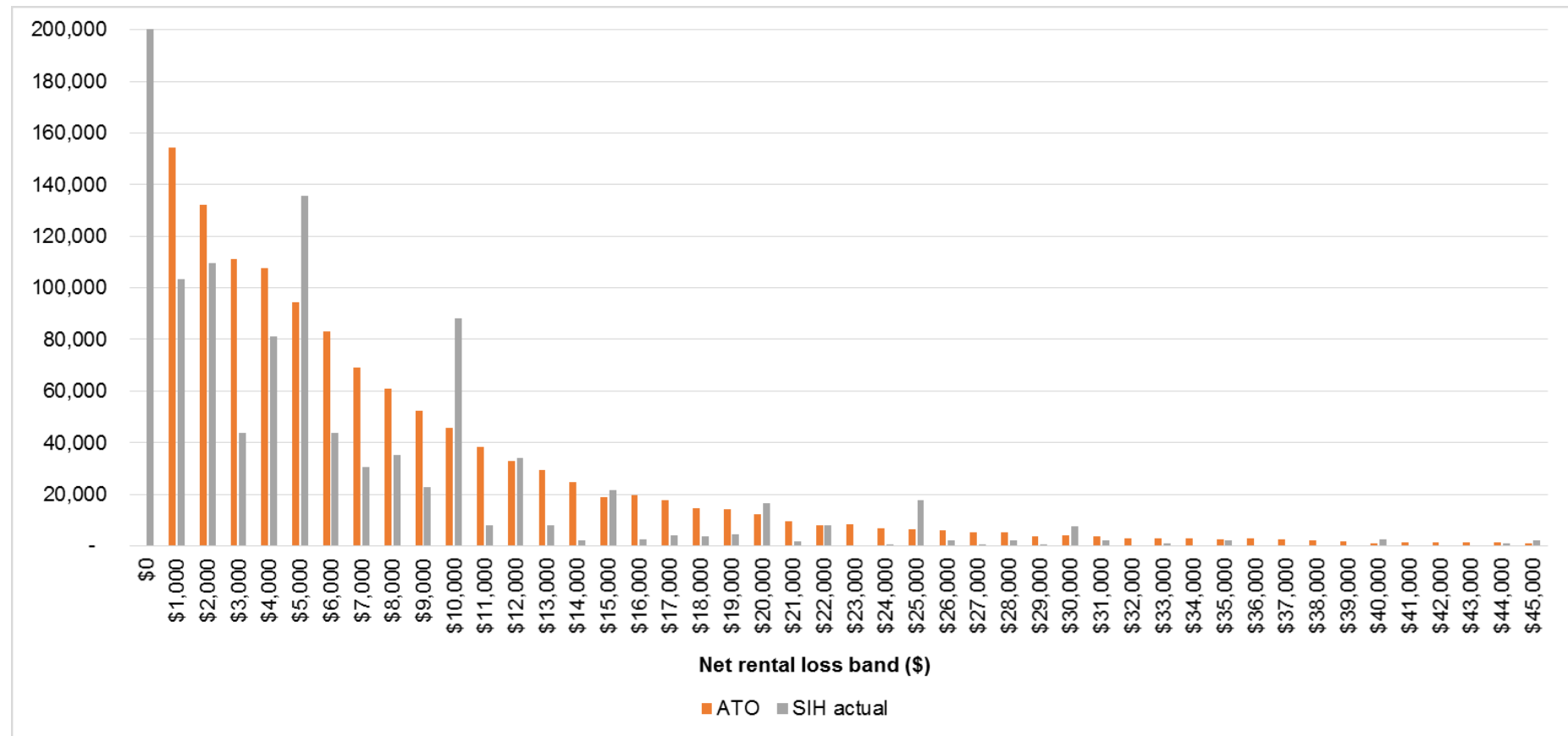
3.1.3 Redistribution of net rental losses: SIH

Figure 2 below compares the distribution of net rental losses between the 2013–14 SIH (grey bars) and 2013–14 ATO 2 per cent sample file (orange bars) in \$1,000 bands. For visual clarity, the vertical axis is capped at 200,000 when in fact over 300,000 investors reported zero net rental loss in the SIH (see Table 2 above), and the horizontal axis is capped at \$45,000 of tax assessable income.

Some clear differences emerge. First, there exists a large number of rental investors in the SIH who report zero rental losses compared to almost none in the ATO data. Second, in the SIH, net rental losses tend to be under-reported relative to the ATO data in most bands, with the grey bars falling below the orange bars in most bands across the distribution. However, some clustering of reported net rental losses can be observed in the SIH at \$5,000, \$10,000, \$20,000, \$25,000 and \$30,000—in all these bands, the grey bars exceed the orange bars in height. This raises questions around the accuracy of reporting by respondents in the SIH given the extensive rounding of loss amounts that appear to have taken place. On the other hand, tax reporting often demands greater accuracy and so the ‘clustering’ effect showing up in the SIH are not observable in the ATO data.

As a result, total net rental losses reported by negatively-geared investors appear to be under-reported in the SIH at \$6.28 billion compared to an ATO total rental loss value of \$10.97 billion. Furthermore, the distribution of total rental losses among negatively-geared investors is smoother in the ATO data than the SIH.

Figure 2: Distribution of net rental losses, SIH and ATO 2 per cent sample file, 2013–14



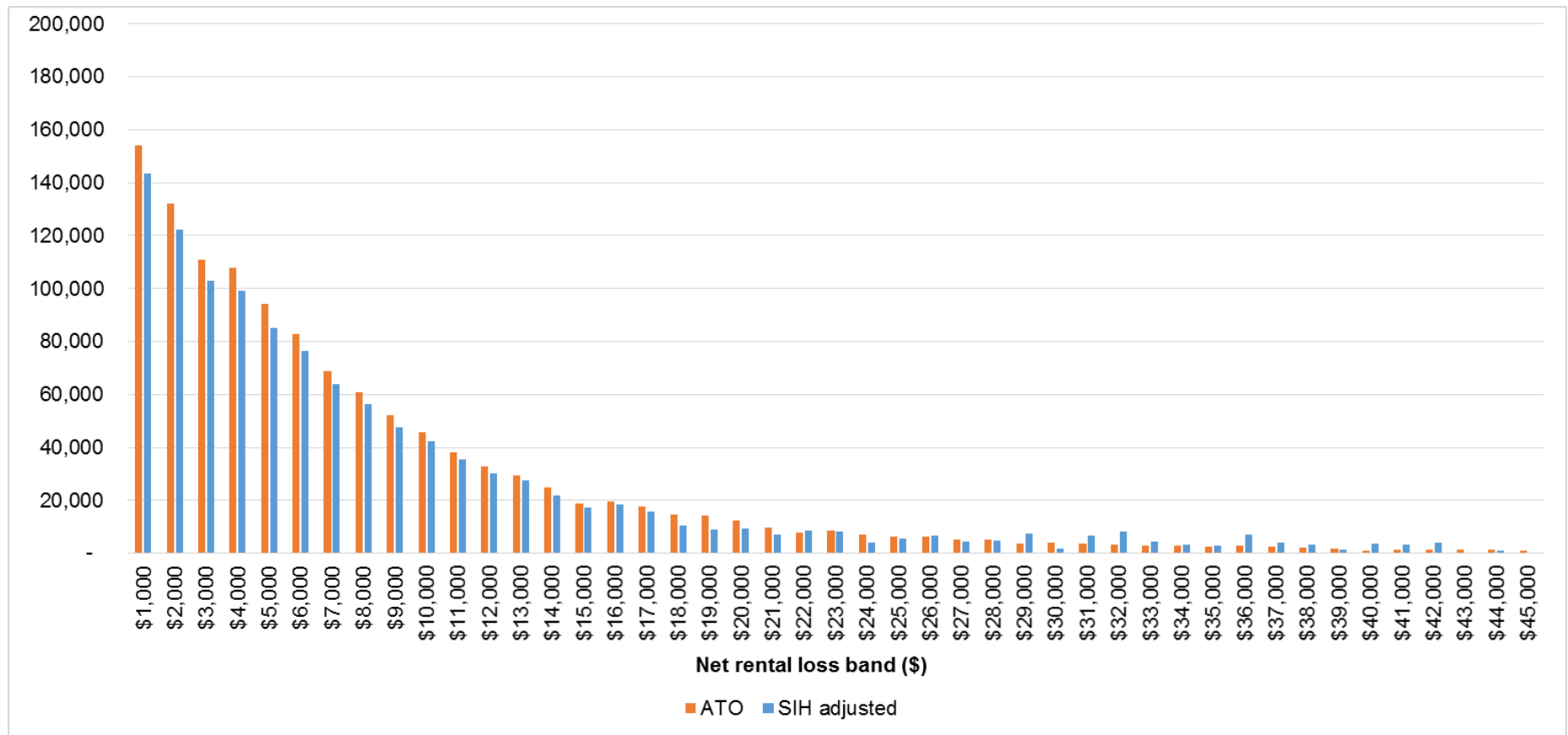
Note: For visual clarity, the vertical axis is capped at 200,000 when in fact over 300,000 investors reported zero net rental loss in the SIH (see Table 2 above), and the horizontal axis is capped at \$45,000 of tax assessable income.

Source: 2013–14 SIH and 2013–14 ATO 2 per cent sample file

The redistribution of net rental losses entail the following steps. We take the sample of rental investors who report either zero or negative rental income in the SIH and rank them from lowest to highest in terms of the net rental income. We do the same for rental investors in the ATO sample file. We then continually redistribute rental investors marginally from one rental income loss band to the next one representing a greater rental income loss till we achieve a redistributed population weighted sample of SIH rental investors with either zero or negative rental income that approximates the distribution of negatively-gearred investors in the ATO data. At this point, the total adjusted rental losses in the SIH are increased to a level that approximates total rental losses in the ATO data.

Figure 3 below compares the distribution of net rental losses again after the redistribution exercise. Once again the horizontal axis is capped at \$45,000 of tax assessable income. A closer distribution of net rental losses is not apparent between the two datasets. Indeed, on an aggregate basis, the adjusted total loss estimates from the 'adjusted' SIH rises from \$6.28 billion to \$10.1 billion, which is more comparable with the ATO's \$10.97 billion. Moreover, the population number of negatively-gearred rental investors rises from 839,870 to 1.15 million after the redistribution of net rental losses, which now approximates the 1.26 million negatively-gearred rental investors in the ATO data.

Figure 3: Distribution of net rental losses, adjusted SIH and ATO 2 per cent sample file, 2013–14



Note: For visual clarity, the horizontal axis is capped at \$45,000 of tax assessable income.

Source: 2013–14 SIH and 2013–14 ATO 2 per cent sample file

3.2 Negative gearing

3.2.1 Characteristics of negatively-gearred versus positively-gearred investors

In Table 3 below, we explore the characteristics of rental investors using the 2013–14 ‘adjusted’ SIH. We ask ‘what are the typical characteristics of rental investors who use negative gearing as opposed to those who do not use negative gearing’. The table reveals that negatively-gearred and positively-gearred investors have somewhat different socio-economic profiles.

The typical negatively-gearred investor is male, aged in his mid-to-late forties and employed full-time. On the other hand, positively-gearred investors tend to be evenly split between males and females, they tend to be older (in their mid-fifties), and similar proportions are employed full-time or not in the labour force (NILF) indicating that many of these investors are in the retirement stages of their life course.

Negatively-gearred investors have an average tax assessable income, or income before deductions, of \$91,000. After deductions are taken into account, the remaining average taxable income for negatively-gearred investors is \$80,000 on average. On the other hand, positively-gearred investors have lower tax assessable incomes of \$78,500 on average, and this only reduces slightly to \$77,500 of taxable income after deductions.

Both types of investors have similar residential rental property values of around \$300,000 on average. However, the differences in their net rental income reflect their different gearing status, with negatively-gearred investors making a loss of around \$8,800 on average while positively-gearred investors make a profit of around \$16,000 on average.

Table 3: Characteristics of rental investors, by geared status, 2013–14, per cent by column unless specified otherwise

Characteristics		Negatively geared	Positively geared	All
<i>Sample</i>		1,798	994	2,792
<i>Population ('000)</i>		1,158,264	650,485	1,808,749
<i>Sex</i>	Male	54.2%	49.1%	53.0%
	Female	45.8%	50.9%	47.0%
	Total	100.0%	100.0%	100.0%
<i>Age (years)</i>	Mean	46	55	49
	Median	47	56	47
	Full-time	68.3%	40.3%	58.2%
<i>Labour force status</i>	Part-time	17.8%	20.3%	18.7%
	Unemployed	2.1%	1.9%	2.0%
	NILF	11.9%	37.5%	21.1%
<i>Tax assessable income (\$/year)</i>	Total	100.0%	100.0%	100.0%
	Mean	\$91,105	\$78,534	\$86,584
	Median	\$67,600	\$51,653	\$62,354
<i>Taxable income (\$/year)</i>	Mean	\$80,370	\$77,490	\$79,334
	Median	\$58,747	\$51,336	\$55,228
	Mean	\$302,893	\$328,229	\$312,004

Characteristics		Negatively geared	Positively geared	All
Residential rental property value (\$)	Median	\$233,333	\$250,000	\$250,000
	Mean	-\$8,780	\$15,990	\$128
Net rental income (\$/year)	Median	-\$5,487	\$5,980	-\$1,946

Notes: Estimates are population weighted on a person basis. For couples, the residential rental property value is divided equally between the partners in the couple.

Source: Authors' own calculations from the 2013–14 SIH

3.2.2 Rental investment histories of negatively-geared versus positively-geared investors: an investigation into investor-churners

Figure 4 below exploits the longitudinal feature of the HILDA Survey to track rental investment spells reported in the HILDA Survey from the first year of spell of rental investment, through to the end of the data collection period in wave 13. We distinguish between two subsets of rental investors—those who were negatively geared throughout their rental investment spell, and those who were positively geared throughout their rental investment spell. We define the beginning of time as the first wave during which a person is recorded as earning rental income, and label it year 0; interest focuses on whether, and when, the spell of rental investment ends. Time is measured in intervals of one year. The unit of analysis is spells, so if a rental investor has three separate rental investment spells during the data timeframe, the rental investor appears three times in the data set.

The hazard rate is the key measure of the ‘risk’ of ending a rental investment spell in each time period. It is the conditional probability that a landlord will realise his/her rental investment given that (s)he did not realise the rental investment in previous time periods. For example, in year 2, the hazard rate is 0.35 for both negatively and positively-geared spells, indicating that 35 per cent of the rental investment spells that constituted the risk set at the beginning of Year 2 ended during year 2. The hazard rate for positively-geared rental investment spells demonstrate a form of negative duration dependence—the longer the spell, the lower the likelihood of it ending. For negatively-geared rental investment spells, the hazard rate also demonstrates negative duration dependence up to year 4, but jumps around quite a bit after that, and is noticeably higher than positively-geared spells during years 5 and 6. Estimates after year 6 are excluded for negatively-geared investors due to small sample sizes.

The survival rate is a measure of the probability that a randomly selected rental investment spell will ‘survive’ into year t , given that it was not realised in the time periods preceding year t . The survival rate trends parallel the hazard rate trends. While both positively and negatively-geared spells exhibit a decline in survival rate over the first few years of the spell, negatively-geared spells do appear to have slightly lower survival rates from year 5.

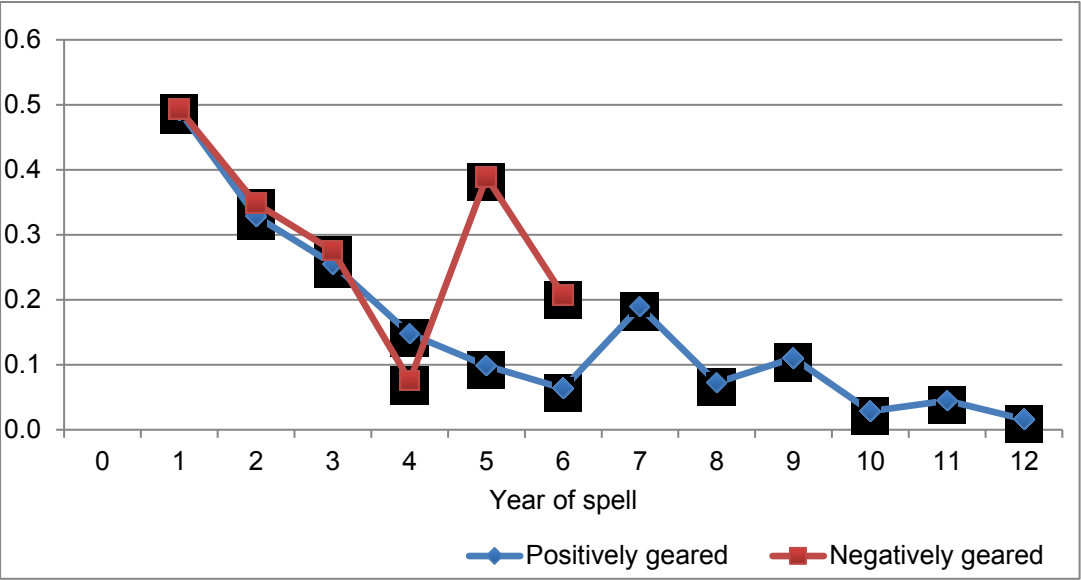
This provides tentative evidence that negatively-geared investors are more likely to terminate rental leases as market conditions change.⁵ Negatively-geared investors make operating losses and hence their rental investment decisions are more sensitive to changes in economic conditions than positively-geared investors. On the one hand, this may have adverse impacts on the tenure security of tenants. On the other hand, there are potential efficiency gains from

⁵ Using a shorter data timeframe (the 2001–06 HILDA Survey), Wood and Ong (2010) found similar evidence of earlier exits from the rental market by negatively-geared landlords than positively-geared landlords.

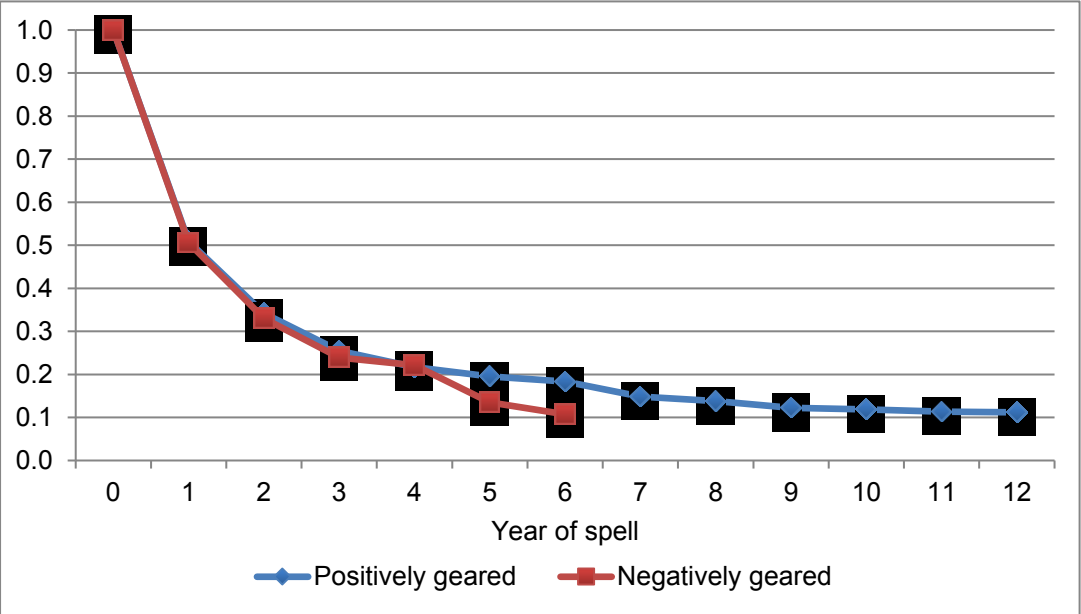
landlords having the flexibility to adjust supply in the rental market in response to changes in housing market conditions (Wood and Ong 2010).

Figure 4: Hazard and survival rates of rental investment spells over the period 2001–13, by rental investors’ gearing status throughout spell

(a) Hazard rate



(b) Survival rate



Notes: Estimates are population weighted on a person basis. The number of negatively-geared cases remaining in the sample dips to below 10 by year 7. Hence, estimates beyond year 6 are excluded due to a lack of statistical reliability.

Source: Authors’ own calculations from the 2001 to 2013 HILDA Survey.

Table 4 below investigates whether those who start out as negatively-geared investors in the new millennium end up churning through multiple rental investment spells more than those who start out as positively geared. It would appear that those who begin as positively-geared

investors are slightly less prone to churning than those who begin as negatively-gearred investors. However, the differences are slight.

Table 4: Number of rental investors with single and multiple rental investment spells during 2001–13, by gearing status when first observed as a rental investor during the timeframe, number and per cent

Number of spells	Negatively geared		Positively geared	
	N	Per cent	N	Per cent
1	978,474	72.8%	1,230,028	73.9%
2	282,472	21.0%	335,198	20.1%
3	52,974	3.9%	67,989	4.1%
4	27,866	2.1%	30,891	1.9%
5	1,890	0.1%	-	0.0%
All	1,343,676	100.0%	1,664,106	100.0%

Notes: Estimates are population weighted on a person basis.

Source: Authors' own calculations from the 2001 to 2013 HILDA Survey.

However, there appear to be some distinctions by location. Table 5 below focuses on rental investors who churn only. The table shows that nearly 23 per cent of investor-churners are located in Melbourne, followed by 17 per cent in Sydney. Among churners, those who are negatively geared are over-represented in all major cities, with the exception of Adelaide, a relatively slow-growth housing market. In major regional areas, where house price growth is slower, positively-gearred investors with multiple spells are over-represented.

Table 5: Distribution of rental investor-churners across locations, by gearing status when first observed as a rental investor during the timeframe, per cent

	Negatively geared	Positively geared	All
<i>Major cities</i>			
Sydney	19.7%	14.8%	17.0%
Melbourne	24.0%	21.7%	22.8%
Brisbane	8.3%	6.6%	7.4%
Adelaide	1.5%	4.3%	3.0%
Perth	11.1%	8.4%	9.6%
<i>Major regional areas</i>			
Rest of NSW	8.5%	10.7%	9.7%
Rest of Victoria	7.4%	8.5%	8.0%
Rest of Queensland	10.8%	11.4%	11.1%
Rest of SA	0.8%	1.6%	1.2%
Rest of WA	2.5%	6.2%	4.5%
<i>Other</i>			
Tasmania	1.1%	3.0%	2.2%

	Negatively geared	Positively geared	All
NT	1.9%	0.4%	1.1%
ACT	2.5%	2.2%	2.4%
All	100.0%	100.0%	100.0%

Notes: Estimates are population weighted on a person basis.

Source: Authors' own calculations from the 2001 to 2013 HILDA Survey.

3.2.3 Negatively-geared investors across tax savings quintiles

In Table 6 below, we investigate which groups among negatively-geared investors have benefited most from negative gearing provisions. Negatively-geared investors are ranked according to the amount of tax savings received due to negative gearing provisions. These investors are then divided equally into five groups or quintiles, with the lowest (highest) quintile representing those receiving the least (greatest) amount of tax savings from negative gearing provisions. Hence, each quintile contains around 20 per cent of negatively-geared investors.

Table 6 shows that the tax savings can range from under \$82 in the lowest tax savings quintile to over \$3,535 in the highest quintile. The distributional analysis across tax savings quintiles enables identification of the characteristics of those who are over-represented in the highest tax savings quintile as opposed to lower quintiles. Those socio-economic groups that are over-represented (>20%) in high tax savings quintiles benefit the most from negative gearing provisions while those who are over-represented (<20%) in the low tax savings quintiles benefit the least from the provisions.

The table shows that negatively-geared investors who are over-represented in high tax savings quintiles and therefore benefit the most are middle-aged males aged 35–54 years old who are full-time employees. On the other hand, the ones who benefit the least are females and older negatively-geared investors aged 55+ years who are not in the labour force.

The biggest beneficiaries from negative gearing provisions are those on relatively high tax assessable incomes, who own relatively high value properties, and who report the largest net rental losses. Indeed, those in the highest tax savings quintile have mean tax assessable income levels of over \$100,000, over ten times the income of those in the lowest tax savings quintile. Those in the highest tax savings quintile also have property values that are 25 per cent on average higher than those in the lowest quintile, and the former report over \$20,000 in annual net rental losses which is nearly three times the value of net rental losses reported by those in the lowest tax savings quintile.

Table 6: Mean tax savings benefits due to negative gearing, by tax savings quintile, 2013–14

Characteristics		Tax savings quintile				
		Lowest (\$0 to \$81)	Second (\$81 to \$828)	Third (\$828 to \$1,757)	Fourth (\$1,757 to \$3,495)	Highest (\$3,495 to \$40,913)
Sex (% by row)	Male	16.3%	17.4%	21.7%	18.9%	25.7%
	Female	23.6%	23.1%	15.0%	19.1%	19.2%
Age band (% by row)	<35 years	17.5%	20.7%	19.3%	23.0%	19.5%
	35–54 years	15.6%	21.5%	18.7%	19.6%	24.6%
	55+ years	30.6%	16.3%	17.9%	15.2%	20.2%
Labour force status (% by row)	Full-time	8.6%	20.4%	19.6%	22.9%	28.5%
	Part-time	29.1%	23.6%	19.8%	14.9%	12.7%
	Unemployed	45.8%	39.0%	6.5%	0.9%	7.8%
	NILF	64.4%	9.5%	13.4%	6.0%	6.6%
Tax assessable income (\$/year)	Mean	\$12,883	\$97,210	\$104,844	\$100,050	\$137,501
	Median	\$5,203	\$60,372	\$75,084	\$83,547	\$102,076
Taxable income (\$/year)	Mean	\$22,019	\$95,682	\$99,602	\$91,798	\$114,355
	Median	\$11,977	\$60,321	\$72,240	\$75,278	\$81,626
Residential rental property value (\$)	Mean	\$294,888	\$278,425	\$287,757	\$281,034	\$362,187
	Median	\$240,000	\$210,000	\$215,000	\$225,000	\$290,000
Net rental income (\$/year)	Mean	-\$7,378	-\$1,938	-\$4,449	-\$7,660	-\$20,530
	Median	-\$4,032	-\$1,278	-\$3,580	-\$6,982	-\$16,070

Notes: Estimates are population weighted on a person basis. For couples, the residential rental property value is divided equally between the partners in the couple.

Source: Authors' own calculations from the 2013–14 SIH.

3.3 Capital gains tax discount

In this section, we shed light on the typical characteristics of housing market participants who benefit differently from CGT provisions. Home owners enjoy 100 per cent CGT discount, rental investors 50 per cent CGT discount, renters no CGT discount. Hence, there are potentially four tenure subgroups who are influenced to different extents by the CGT discount.

First, those who do not own rental investment properties ('home owners only' and 'renters only' in Table 7 below) make up the two largest groups. Home owners only receive the 100 per cent CGT discount that applies to the family home. Renters who do not own rental investment properties receive no CGT discount at all as they do not own properties that make capital gains.

Home-owner investors own both a family home and at least one rental investment property. While they are much smaller in number than either home owners only or renters only, they benefit the most from CGT discount provisions as they enjoy a 100 per cent CGT discount on the family home and a further 50 per cent discount on rental investment properties.

Finally, a small but not insignificant group of just under 400,000 renter-investors exists. These do not live in a home that they own, but they are renting out properties that attract a 50 per cent CGT discount.

Table 7: Housing market participants who benefit differently from CGT, 2013–14, per cent by total

	Tax savings	Sample	Population	Per cent
Home-ownerinvestors	100% CGT discount on owner occupied property, 50% CGT discount on rental property	2,244	1,409,079	7.4%
Home owners only	100% CGT discount	13,747	8,767,436	45.8%
Renter-investors	50% CGT discount on rental property	548	399,670	2.1%
Renters only	No tax savings	10,726	8,574,668	44.8%
All		27,265	19,150,853	100.0%

Source: Authors' own calculations from the 2013–14 SIH.

Table 8 below compares the characteristics of the four subgroups listed in the previous table. The comparison aims to shed light on the characteristics of each of these groups to detect systematic differences between groups that benefit differently from CGT discount provisions, ranging from home-owner investors who benefit from CGT discounts on multiple properties to renters only who receive no CCT discounts.

The table shows clearly that those who rent (renter-investors and renters only) tend to be younger than those who own a family home, potentially reflecting life course related housing tenure pathways. The median renter only is aged 32 years, followed by renter-investors who are aged 42 years, and finally those who have a family home who are typically in their early fifties. There is also a sharp distinction in labour force status across the four subgroups. Those who own investment properties are more likely to be employed full-time and therefore have higher tax assessable incomes. Those who do not own investment properties are over-represented among the NILF group.

An obvious pattern that emerges is that CGT discount benefits are heavily weighted towards those who are more affluent. This skew is obvious when we compare the incomes and property assets of the four subgroups. Home-owner investors who own both a family home and at least one rental investment property have the highest average income of \$82,000. On the other hand, renters who do not own any properties have the lowest average income of \$31,000, less than half of home-owner investors' mean income.

On average, a home-owner investor can own a property portfolio worth over \$730,000 (\$420,000 average primary home value plus \$310,000 average rental investment property value). Those who own a family home but not rental properties, and those who own rental properties but not a family home, typically have property wealth sitting at around \$340,000. On the other hand, renters who do not own any properties have no property wealth.

Hence, the benefits of CGT discounts are clearly greater the greater the number of properties and the higher one's income level.

Table 8: Characteristics of housing market participants who benefit differently from CGT provisions, 2013–14, per cent by column unless specified otherwise

Characteristics		Home owner-investors	Home owners only	Renter-investors	Renters only
<i>CGT discount type</i>		100% on family home and 50% on rental properties	100% on family home	50% on rental properties	No discount
Sex	Male	51.5%	46.7%	58.4%	50.6%
	Female	48.5%	53.3%	41.6%	49.5%
	Total	100.0%	100.0%	100.0%	100.0%
Age (years)	Mean	51	54	43	35
	Median	52	52	42	32
	Full-time	54.5%	38.8%	59.6%	33.5%
Labour force status	Part-time	21.4%	19.9%	20.9%	23.3%
	Unemployed	1.7%	2.7%	3.0%	9.3%
	NILF	22.4%	38.7%	16.5%	34.0%
Taxable income (\$/year)	Total	100.0%	100.0%	100.0%	100.0%
	Mean	\$81,596	\$49,463	\$71,362	\$30,844
	Median	\$56,203	\$31,573	\$52,572	\$19,916
Primary home value (\$)	Mean	\$417,904	\$340,536	N/A	N/A
	Median	\$335,000	\$275,000	N/A	N/A
Residential Rental property value (\$)	Mean	\$308,534	N/A	\$324,240	N/A
	Median	\$240,000	N/A	\$250,000	N/A

Notes: Estimates are population weighted on a person basis.

Source: Authors' own calculations from the 2013–14 SIH.

3.4 Policy development implications

The key findings from this chapter have primary policy development implications.

First, negative gearing and CGT discount benefits are heavily skewed towards those who are more affluent, raising issues around the extent to which such policies exacerbate income and wealth inequality among the Australian population. Negatively-gearred rental investors making a loss of around \$8,800 on average while positively-gearred investors make a profit of around \$16,000 on average. However, negatively-gearred investors have noticeably higher tax assessable incomes than positively-gearred investors. The former reported an average tax assessable income of \$91,000 in the 2013–14 SIH compared to \$78,500 among positively-gearred investors. Among negatively-gearred investors, those who receive the greatest tax savings are also those who have the highest incomes and rental property values, and greatest annual net rental losses. Similarly, CGT discount benefits are heavily weighted towards those who are more affluent in terms of both income and property wealth. On average, a home-owner investor can own a property portfolio worth over \$730,000. Home-owner investors' average tax assessable income is \$82,000 compared to \$31,000 among renters who do not own any

properties. Hence, any reforms to negative gearing or CGT ought to ensure that it reduces inequities inherent within the current systems by reducing tax savings by proportionately greater amounts for those who have relatively high income or asset levels.

A second but tentative policy implication derives from the longitudinal analysis of rental investment spells in the HILDA Survey. It would appear that negatively-geared investors may be more likely to terminate rental leases as market conditions change. Negatively-gearred investors make operating losses and hence their rental investment decisions are more sensitive to changes in economic conditions than positively-gearred investors, so this finding is not surprising. However, the policy implications are mixed. On the one hand, this may have adverse impacts on the tenure security of tenants and indeed overall housing market stability. On the other hand, as suggested by Wood and Ong (2010), there are potential efficiency gains from landlords having the flexibility to adjust supply in the rental market in response to changes in housing market conditions.

4 Negative gearing and capital gains tax: impacts of proposed reforms and transitional arrangements

- If the key policy concern is that a tightening of negative gearing parameters will impact ‘mum and dad’ investors’ economic wellbeing negatively and result in a behavioural decision by such investors to withdraw from the rental housing market, then it is likely that a progressive rental deduction that cushions ‘mum and dad’ investors from significant drops in tax savings will be a more appropriate policy option than a more blunt cap on rental deductions.
 - A progressive rental deduction that distinguishes between ‘mum and dad’ and ‘sophisticated’ investors has the potential to reduce inequities inherent in the current systems by reducing tax savings by proportionately greater amounts for those who have relatively high income or property asset levels than general rental deduction caps.
 - However, it is noteworthy that progressive rental deduction reforms are likely to be administratively more complex to implement than a cap. Moreover, the progressive nature of the reform may blunt incentives to work by investors.
 - A reduction in CGT discount will narrow the gap in after-tax economic cost burdens that lower income and higher income rental investors have to bear, reducing inequities within the current system that favour higher income earners compared to lower income earners.
 - A gradual reduction in the discount would ‘soften’ the impact of the CGT reform by providing a transition pathway that raises the after-tax economic cost of holding rental investment housing incrementally.
-

This chapter addresses the report’s third and fourth research questions:

What are the revenue and distributional impacts of different negative gearing and CGT reform scenarios on housing investors and the Federal budget?

What potential transitional arrangements might minimise the revenue and distributional pressures during the process of reform?

We begin by providing a summary of proposed reforms and transitional arrangements relating to negative gearing and CGT in the existing literature in section 4.1, and what the current findings are in relation to the impacts of these proposed changes. We follow this by reporting results from a series of policy simulations designed to test for the impacts of alternative variants of reforms to negative gearing and CGT discounts on landlords’ after-tax incomes, and where possible, budgetary savings that might be derived from the reforms. We focus on negative gearing reforms in section 4.2 and CGT discounts in section 4.3.

4.1 Existing research on this chapter’s theme

Proposals to reform the taxation of investment housing are generally based on addressing the asymmetry between negative gearing and capital gains. In order to limit adverse effects on the

housing market, which is vulnerable to shocks arising from changes in policy, most proposals advocate that changes be phased in over time.

Recommendation 13 of the Senate inquiry into housing affordability (Economics References Committee 2015) identified the following options for reform:

- a housing specific quarantining measure that limits deductibility of expenses from housing to income from housing
- a broader investment quarantining measure that limits deductions in relation to investment income to the amount of income received
- a targeted approach that allows negative gearing in respect of new or affordable housing
- restricting negative gearing to a specified number of properties
- applying the recommendations in the Henry Review to allow a 40 per cent discount to income and expenses in relation to investment properties
- reducing or removing the CGT discount.

A number of OECD jurisdictions limit the deductibility of rental losses against either income from rents or more broadly income from investment (see Table 1).

In the context of losses from specific activities, there are examples in the existing Australian taxation law where the losses from particular activities are not taken into account against income from other sources. This practice, referred to as 'quarantining' of losses is required in respect of the losses of certain small businesses. A number of measures in relation to the taxation of foreign source income also aggregate and quarantine income from specific sources to calculate the rate of Australian tax, or available credits, in respect of that income.

During the period from 1985–87 there was a statutory restriction on the tax deductibility of interest. The Hawke/Keating Government introduced legislation to limit the tax deductibility of interest on borrowing used to acquire property after July 1985 to the net rental income remaining after deducting all non-interest expenses other than the building capital write-off. These provisions, which only applied to new loans and only to loans for rental properties, predated the introduction of the capital gains tax by about two months.

The quarantining provisions were repealed in the 1987 budget following a sustained campaign against the restriction. At the time of the repeal, Keating referred to the introduction of the Capital Gains Tax as an alternative way to address the tax shelter (Cabinet Office 1987).

As noted by the Senate Economics Committee, the effect of quarantining negative gearing remains one of the most contentious areas of tax policy (Economics Reference Committee 2015, paragraph 9.65)

Evans, Minas et al. (2015) discussed the replacement of the CGT discount with an annual CGT exemption cap. It is argued that this reform would impose capital gains tax on larger gains, which would improve the equity and efficiency of the CGT.

Grudnoff (2015) proposed the removal of the CGT discount combined with changes to negative gearing to allow deductions for up to ten years after construction of new housing. Existing properties would be grandfathered for five years only.

In the 2016 Federal Election campaign reforms to negative gearing were proposed by the Australian Labor Party (ALP 2016) and the Australian Greens (2016).

The ALP proposal would limit negative gearing to properties acquired before 1 July 2017 and newly constructed properties after that date, coupled with changes to the CGT discount to reduce the discount to 25 per cent for assets acquired after 1 July 2017 (ALP 2016).

The Parliamentary Budget Office (PBO) modelled the cost of this proposal as saving \$1,929m over the 2016–17 forward estimates period; although it noted that the savings would increase after the end of that period (PBO 2016: Table B-1, ALP 015).

Phillips (2016) modelled the impact of the ALP proposals to remove negative gearing for properties (that are not newly constructed) acquired from 1 July 2017 and reduced the magnitude of the CGT discount to 25 per cent.

Phillips (2016) finds that the benefits of negative gearing are highly skewed towards the top decile of family income, estimating that in the 2017–18 year the cost to the revenue from negatively geared properties is \$4.3 million. Specifically, the distributional analysis shows that 21.7 per cent of the population of negatively-geared investors are in the top decile of family income, and this decile's share of the tax savings is 35.2 per cent. For each of the other nine deciles the share of the tax saving is less than the proportion of negatively gearing investors in the respective decile. For example, the second highest (9th) decile includes 17.5 per cent of negatively-geared investors and their share of the overall savings from negative gearing is 17.4 per cent, and the fifth decile consists of 7.5 per cent of investors who receive 5.6 per cent of the tax savings.

The Greens proposal would have removed negative gearing from all new investments, including residential real estate, from 1 July 2017, and reduced the CGT discount by 10 per cent per annum over the next five years until it is phased out. This proposal was submitted to the PBO too late to be formally costed during the election period, but in the post-election report the PBO estimated that the proposal would have saved \$14,426 million over the 2016–17 forward estimates period. The proposal would have higher savings after the end of the forward estimates period (PBO 2016: Table C-1, GRN 094). The Greens policy has since been further refined to immediately remove negative gearing from all investors with more than one investment property (Di Natale 2017).

The model proposed in the Henry Review to include 40 per cent of income and allow 40 per cent of expenses was modelled by Wood, Ong et al. (2011). This report found that negatively-geared investors would be adversely affected by the change that could lead to their exit from the investment housing market. However, the market effect would be offset by the incentive for equity investors to retain their investment properties.

A further proposal to limit negative gearing is the introduction of a global cap on all deductions that a taxpayer can claim (Warren 2014). Tran-Nam and Evans noted that the introduction of standard deductions in the context of work-related deductions may have perverse outcomes by encouraging taxpayers to claim up to the cap regardless of actual expenditure (Tran-Nam and Evans 2012). A similar cap has been introduced in the UK to limit tax reliefs to the greater of £50,000 or 25 per cent of income. However, this cap does not apply to interest on rental properties as from 6 April 2017 relief on mortgage interest costs is separately limited to the base rate of tax (HMRC 2017).

There is no consensus in public debate over which taxpayers are most likely to access negative gearing concessions. Government spokespersons say that most negatively-geared investors earn a taxable income of less than \$80,000 per annum, and have only one property (O'Dwyer 2015; Morrison 2016). However, this claim has been criticised on the basis that the data is based on taxable income, after deductions related to rental properties; and that only 20 per cent of taxpayers have taxable incomes over \$80,000 (Daly and Wood 2016; Phillips and Joseph 2015).

4.2 Negative gearing

4.2.1 Reform simulations

In this section, we present the results from a range of negative gearing reform simulations, drawing on the reforms proposed in the existing literature in the previous section. The impacts of all proposed reforms are compared against the actual scenario, where rental expenses receive a 100 per cent deduction against both rental and non-rental taxable income sources.

As highlighted in Chapter 3, negative gearing and CGT discount benefits are heavily skewed towards those who are more affluent, potentially exacerbating income and wealth inequality among the Australian population. As such, a complete abolition of negative gearing and CGT discount benefits has the potential to achieve a desirable reduction in income and wealth inequality. Moreover, the abolition of negative gearing has the potential to ease competition for housing in the market between first home buyers and investors, and hence reduce crowding out of first home buyers from the market.

However, policy commentators have long raised concerns around potentially undesirable effects of such reforms. Indeed, a complete abolition of negative gearing reforms has often been criticised by policy-makers for its potentially adverse impacts on the financial wellbeing of ‘mum and dad’ investors. Concerns have also been raised regarding a potential ‘flight’ of investors from the rental market should negative gearing and CGT benefits be abolished, resulting in a shortage of rental housing supply which in turn adversely affects rental affordability.

Overall, a complete abolition of negative gearing and CGT discount benefits are typically viewed as being politically unpopular. Hence, in this section we explicitly model transitional arrangements that are designed to moderate the impacts of a reduction in negative gearing and CGT benefits through policy reform. We draw primarily on the EVITA microsimulation model operationalised on SIH data on negatively-g geared investors that have been adjusted via the redistribution of net rental losses described in Chapter 3. The following are the simulations that are modelled and reported in this chapter.⁶

Progressive rental deduction

As mentioned above, a complete abolition of negative gearing reforms has often been criticised by policy-makers for its potentially adverse impacts on the financial wellbeing of ‘mum and dad’ investors. Indeed, as mentioned in section 4.1, a key recommendation in the 2015 Senate inquiry into housing affordability was to restrict negative gearing benefits to a limited number of properties (Economics References Committee 2015). It is suggested that this approach might better target rental investors looking to diversify their retirement savings while limiting large deductions being claimed against high-value property portfolios (AHL Investments Pty Ltd 2014). This approach has an added benefit of potentially performing the role of a transitional measure that can potentially act as a stepping stone to a complete abolition of negative gearing in the future.

In our first set of simulations, we distinguish between ‘mum and dad’ and ‘sophisticated’ investors⁷ and apply more generous concessions to the former. We differentiate between these investor groups in two different ways:

⁶ A full behavioural examination of alternative negative gearing options is beyond the scope of this report, for the reasons discussed earlier. Nevertheless, the recalibration in EVITA of net rental losses between SIH and ATO makes possible some unique analysis of distributional impacts, transitional arrangements and policy costing of alternative negative gearing reform options.

⁷ Note that the term ‘sophisticated investor’ is used to describe an investor with multiple rental properties. It does not infer that the investor would meet the criteria of s.708 of the *Corporations Act 2001* to be described as a

- **Income-based:** First, we differentiate low, middle and high-income rental investors. The assumption here is that ‘mum and dad’ investors are more likely to have low to moderate incomes, while sophisticated investors are more likely to be concentrated in higher income ranges. We simulate a reform whereby rental investors in the bottom 50 per cent of the income distribution continues to receive a 100 per cent rental deduction, those in the 51st–75th percentiles receive a lower 50 per cent rental deduction, and those in the 76th–100th percentiles receive zero rental deductions, with this upper quartile representing ‘sophisticated’ investors.
- **Property-based:** Second, we differentiate between ‘mum and dad’ and ‘sophisticated’ investors based on a number of properties criteria. We assume that ‘mum and dad’ investors are more likely to own one rental property while sophisticated investors are more likely to own multiple properties. We simulate a reform whereby rental investors in the bottom 50 per cent of the rental property value distribution continues to receive a 100 per cent rental deduction, those in the 51st–75th percentiles receive a lower 50 per cent rental deduction, and those in the 76th–100th percentiles receive zero rental deductions, with this upper quartile again representing ‘sophisticated’ investors.

Rental deduction cap

A popularly mooted form of negative gearing is the quarantining of negative gearing in some form. The previous section provides more details, but it is obvious that these have been proposed in Australia more than once historically—including recommendations by the 2015 Senate inquiry into housing affordability which were not implemented (Economics References Committee 2015) and the quarantining legislation implemented in 1985, though it was short-lived and repealed after just two years. We model a transitional arrangement towards a complete quarantining of negative gearing by applying rental deduction caps at progressively stringent levels. One of Warren’s (2014) modelling exercises for the UK sets deductions at a cap of £25,000, then £50,000, followed by £50,000 increments in cap levels to £200,000. Another exercise models the tax relief achieved at the greater of £50,000 or 25 per cent of income. Here, we follow a similar approach by modelling the following caps on rental deductions, comprising a stepped transition from more generous to less generous deduction limits for negatively-gearred investors:

- \$40,000 cap
- \$30,000 cap
- \$20,000 cap (equivalent to around 25 per cent of tax assessable income)
- \$10,000 cap
- \$5,000 cap.

Note a \$0 cap would result in a full quarantining of negative gearing.

4.2.2 Distributional impacts

Table 9 below presents results from simulations of progressive rental deductions based on both income-based and property-based percentiles, with ‘mum and dad’ investors represented in the lower to moderate income ranges and ‘sophisticated’ investors represented in the upper quartiles. ‘Mum and dad’ investors in the bottom half of the income distribution receive mean tax savings of \$742. The mean tax savings received by investors rise as one progresses up the income distribution scale. At the upper income quartile, ‘sophisticated’ investors receive an

sophisticated investor. It also refers to individual investors and so the definition excludes institutional investment in rental housing.

average of \$3,149 in tax savings, over four times the savings received by investors in the bottom half of the income distribution. When the distribution is measured on a property value basis, the trend is the same, though the increase in mean tax savings is less steep as one moves up the property value distribution, from \$1,336 to \$2,156.

Under the proposed reforms, 'mum and dad' investors in the bottom half of the income and property value distributions are excluded from any reduction in rental deductions and therefore experience no reduction in tax savings. At the other extreme, those in the upper quartile are subject to a full quarantine of negative gearing and therefore receive zero rental deductions, resulting in a complete loss of their tax savings from negative gearing.

Those in the 50th to 75th percentiles receive a 50 per cent rental deduction, a less severe measure than zero rental deductions. 'Mum and dad' investors in this group lose around half of their rental deductions. They are therefore cushioned from a complete loss of their rental deductions, and less likely to exit the rental market than if they were subject to a full quarantining of negative gearing. Such a measure is therefore also a potential transitional arrangement that could ease the pathway towards a complete negative gearing quarantine for all rental investors over time.

Table 9: Mean tax savings of progressive rental deduction reforms on negatively-geared investors, 2013–14

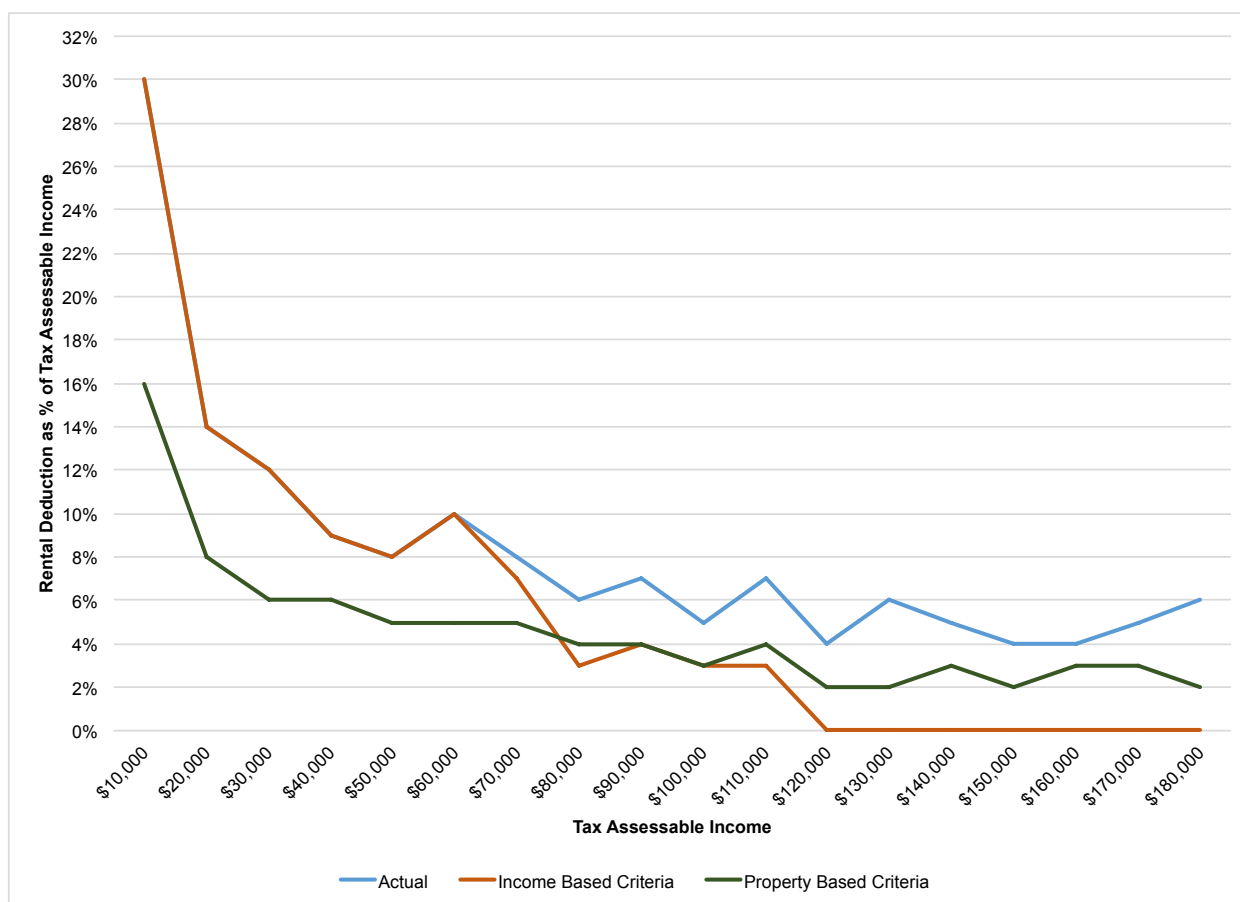
	Percentile					
	Income-based criteria			Property-based criteria		
	<=50%	50th–75th	76th–100th	<=50%	50th–75th	76th–100th
Actual:						
Mean tax savings (annual \$)	\$742	\$2,362	\$3,149	\$1,336	\$1,567	\$2,156
Reform:						
Mean tax savings (annual \$)	\$742	\$1,203	\$0	\$1,336	\$752	\$0
Mean reduction in tax savings						
Annual \$	\$0	\$1,159	\$3,149	\$0	\$815	\$2,156
Per cent	0.0%	-49.1%	-100.0%	0.0%	-52.0%	-100.0%

Notes: Estimates are population weighted on a person basis.

Source: Authors' own calculations from the 2013 SIH.

Figure 5 below charts the average rental deductions profile of negatively-geared investors across the tax assessable income distribution under the actual and two progressive rental deductions scenarios. In general, the amount of rental deductions (expressed as a percentage of income) decline as income increases. However, it is clear that under the income-based progressive rental deduction scenario, the level of average rental deductions will decline more steeply than under the actual setting, with rental deductions hitting zero beyond the 75th income percentile. Hence, the income-based reform will result in a harder 'hit' to higher income investors than lower income investors. The property-based reform results in a general lowering of rental deductions across all income levels, but still maintains a decline in rental deductions as income rises. Of course, while not shown here, the rental deductions under the property-based reform would decline steeply as the rental property value rises, hitting zero beyond the 75th property value percentile.

Figure 5: Distributional impacts of progressive rental deduction reforms, 2013–14



Notes: Estimates are population weighted on a person basis.

Source: Authors' own calculations from the 2013 SIH.

Table 10 below presents the results of another set of simulations that centre around the application of caps or limits on the amount of rental deductions that individual rental investors are permitted to receive. The table presents an array of results that reflect a potential transition from a generous cap of \$40,000 to increasingly restrictive cap levels. The average tax savings that rental investors receive from negative gearing is \$1,615. This reduces only very slightly by \$25 under a generous \$40,000 cap. If the cap is halved to \$20,000, an average of \$244 in tax savings resulting in a 15 per cent reduction in tax savings to \$1,371. This declines steeply to just \$694, a decline of over 50 per cent, if the cap is further reduced to \$5,000.

Table 10: Mean tax savings of rental deduction caps, 2013–14

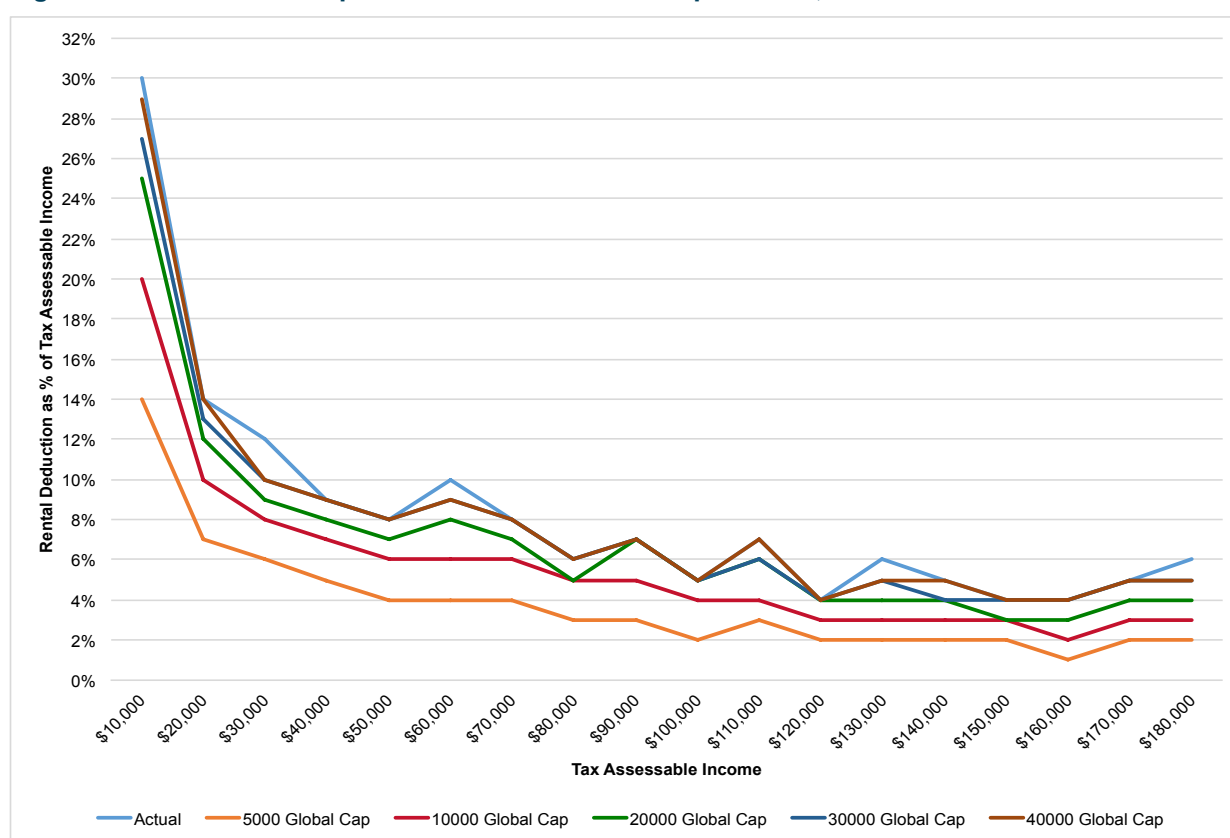
	All	Rental deduction cap				
		\$40,000	\$30,000	\$20,000	\$10,000	\$5,000
Actual:						
Mean tax savings (annual \$)	\$1,615	\$1,590	\$1,526	\$1,371	\$1,053	\$694
Reform:						
Mean tax savings reduction						
Annual \$	N/A	\$25	\$89	\$244	\$562	\$921
Per cent	N/A	1.5%	5.5%	15.1%	34.8%	57.0%

Notes: Estimates are population weighted on a person basis.

Source: Authors' own calculations from the 2013 SIH.

Figure 6 below profiles the average rental deductions across tax assessable income ranges under incrementally stricter cap levels. Regardless of cap level, the amount of rental deductions decline as a percentage of tax assessable income as income rises. As expected, a generous global cap of \$40,000 would result in little deviation from the actual setting. Reducing the cap levels will result in increasingly lower levels of rental deductions across the income distribution.

Figure 6: Distributional impacts of rental deduction cap reforms, 2013–14



Notes: Estimates are population weighted on a person basis.

Source: Authors' own calculations from the 2013 SIH.

4.2.3 Revenue impacts

The estimated budgetary cost of negative gearing generated from EVITA operationalised on the 2013–14 SIH (after the redistribution exercise) is \$3.04 billion. The reform simulations conducted above yield aggregate revenue impacts, which are derived from the SIH data by applying population weights to each negatively-gearred investor in the data set and aggregating the reduction in tax savings experienced by each individual under each reform. The sum of the tax savings reduction under each reform is the overall reduction in budgetary cost yielded by the reform. This is comparable with negative gearing costs from other publications that draw from ATO data. For instance, Grudnoff (2015) reported an estimated cost of negative gearing of \$3.7 billion. The Greens Western Australia (2016) estimated the cost of negative gearing to be \$4 billion, and Eslake's (2013) submission to the senate inquiry into housing affordability suggest a higher cost of \$5 billion, though it assumes that all landlords are in a 38 per cent income tax bracket.

Each negative gearing reform simulated in this report will reduce the amount of tax savings that investors can derive from negative gearing. Hence, each will give rise to cost savings for the Federal Government. Table 11 below documents the impact of each negative gearing reform on government budgets. These range widely depending on the severity of the reform.

Progressive rental deductions on income (property) based criteria will reduce the budgetary cost of negative gearing by \$1.74 billion (\$1.47 billion) or 57 per cent (48%), as tax savings benefits are tightened for more sophisticated rental investor subgroups.

The budgetary cost of each rental deduction cap reform rises as the cap level rises as the number of individuals whose tax assessable incomes are affected by the reform is reduced. Hence, the reduction in budgetary cost narrows from over half for a \$5,000 cap to one-third for a \$10,000 cap, to under 2 per cent for a \$40,000 cap. Broadly similar conclusions are drawn by Daley and Wood's (2016) modelling of the same reform. They find a \$5,000 cap in 2015–16 would have the impact of reducing the budgetary cost of negative gearing by \$1.3 billion as compared to \$1.74 billion for 2013–14 in this report. Similarly, they find that a \$20,000 cap would reduce budgetary costs by \$0.3 billion compared to \$0.46 billion in this report.

Table 11: Revenue impacts of negative gearing reforms, 2013–14

		Budgetary cost	Mean reduction in budgetary cost	
		billion \$	billion \$	%
<i>Actual</i>		3.04		
<i>Progressive rental deduction</i>	Income-based	1.30	1.74	57.3%
	Property-based	1.57	1.47	48.3%
<i>Rental deduction cap</i>	\$40,000	2.99	0.05	1.6%
	\$30,000	2.87	0.17	5.5%
	\$20,000	2.57	0.46	15.3%
	\$10,000	1.98	1.06	34.8%
	\$5,000	1.30	1.73	57.0%

Notes: Estimates are population weighted on a person basis.

Source: Authors' own calculations from the 2013 SIH.

4.3 Capital gains tax discount

4.3.1 Impacts on net income

In this section, we model the likely impacts of a transitional CGT reform on the net income of a typical rental investor using EVITA operationalised on the 2013–14 SIH. Due to the cross-sectional nature of the SIH, it is not possible to observe the capital gain of properties that when sold would in turn attract a CGT discount. Moreover, the SIH does not record information on property sales transactions.

While there are more limitations to what we can do in CGT simulations than negative gearing simulations due to data restrictions, we can nevertheless conduct analysis of the impacts of CGT reform from a perspective of a typical investment strategy. From the 2013 SIH, we observe that a typical rental investor is male, aged 50 and employed full-time. He owns a rental property that is valued on average \$350,000 and his gross annual income is \$85,000 per year, which attracts an MITR of 37 per cent. We therefore analyse the implications of reducing the CGT discount on the net income of this typical investor.⁸

We simulate a transitional measure reflecting a gradual tightening of the CGT discount, from the actual discount rate of 50 per cent, to 40 per cent, 30 per cent, 20 per cent, 10 per cent and 0 per cent (complete abolition of the discount). This is modelled over a range of capital gains scenarios at 10 per cent increments, reflecting capital gains that would eventuate under slow to high-growth market conditions. Because the average rental property is valued at \$350,000, a

⁸ We assume the typical investor is single with no children. This controls for the impact of a partner's characteristics on after-tax income.

10 per cent capital gain would amount to \$35,000, the next 10 per cent increment would result in a 20 per cent capital gain of \$70,000, and so on.

Table 12 below reports the impact of CGT reform across a range of discount and capital gains scenarios. The table displays some clear trends. Under current settings, a typical rental investor with a gross annual income of \$85,000 will receive \$92,591 upon sale of his rental property if capital gains are 10 per cent. The higher the capital gains rate, the greater net income will be upon sale of the property. So if capital gains are 20 per cent (50%), the sale of the rental property would increase net income to \$120,853 (\$205,641) for the same investor.

Holding capital gains constant, a reduction in CGT discount rate from 50 per cent to 0 per cent will result in increasingly greater reductions in after-tax or net income. For instance, consider a 30 per cent capital gains scenario. Under current settings, a typical rental investor with gross annual income of \$85,000 will receive \$149,116 upon sale of his rental property. If the discount rate were reduced to 40 per cent, the investor's net income will decline by \$4,043 (or 2.7%). If CGT discount were completely abolished, the investor would suffer a reduction in net income of \$21,013 (or 14.1%). Hence, the greater the reduction in CGT discount rate and the higher the capital gains upon sale, the greater the reduction in net income for investors.

Table 12: Impact of a reduction in CGT discount on the net income of a typical rental investor with gross annual income of \$85,000, 2013

Capital gains in \$	CGT discount					
[% in brackets]	Actual: Net income on sale	Reforms: Reduction in net income compared to actual scenario				
	50%	40%	30%	20%	10%	0%
\$35,000 [10%]	\$92,591	-\$1,348 (-1.5%)	-\$2,695 (-2.9%)	-\$4,042 (-4.4%)	-\$5,390 (-5.8%)	-\$6,738 (-7.3%)
\$70,000 [20%]	\$120,853	-\$2,695 (-2.2%)	-\$5,390 (-4.5%)	-\$8,085 (-6.7%)	-\$10,780 (-8.9%)	-\$13,475 (-11.2%)
\$105,000 [30%]	\$149,116	-\$4,043 (-2.7%)	-\$8,085 (-5.4%)	-\$12,128 (-8.1%)	-\$16,170 (-10.8%)	-\$21,013 (-14.1%)
\$140,000 [40%]	\$177,378	-\$5,390 (-3.0%)	-\$11,020 (-6.2%)	-\$17,530 (-9.9%)	-\$24,040 (-13.6%)	-\$30,550 (-17.2%)
\$175,000 [50%]	\$205,641	-\$7,538 (-3.7%)	-\$15,675 (-7.6%)	-\$23,813 (-11.6%)	-\$31,950 (-15.5%)	-\$40,088 (-19.5%)

Note: A typical rental investor is a male, aged 50 years, employed full-time, who owns a rental property valued at \$350,000 and earns a gross annual income of \$85,000.

Source: Authors' own calculations from EVITA, 2013 SIH.

Next, we repeat the simulation for a typical rental investor who possesses all the characteristics described previously. However, we vary his income in this instance so it is double the amount earned by a typical investor. Since the CGT discount is applied at the highest MITR of the rental investor, the doubling of income propels the investor from an MITR of 37 per cent to 45 per cent. Table 13 below displays the same patterns across CGT discount rates and capital gains rates. The greater the reduction in CGT discount rate and the higher the capital gains upon sale, the greater the reduction in net income for investors.

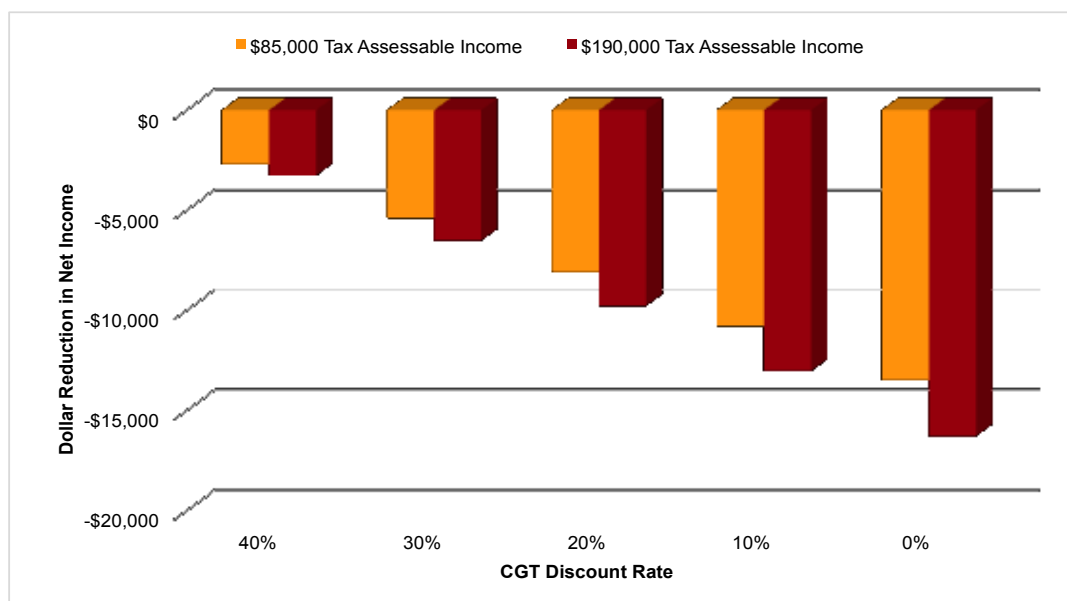
Table 13: Impact of a reduction in CGT discount on the net income of a typical rental investor with gross annual income of \$190,000, 2013

Capital gains in \$ [% in brackets]	CGT discount					
	Actual: Net income on sale	Reforms: Reduction in net income compared to actual scenario				
		50%	40%	30%	20%	10% 0%
\$35,000 [10%]	\$154,966	-\$1,628 (-1.1%)	-\$3,255 (-2.1%)	-\$4,883 (-3.2%)	-\$6,510 (-4.2%)	-\$8,138 (-5.3%)
\$70,000 [20%]	\$181,828	-\$3,255 (-1.8%)	-\$6,510 (-3.6%)	-\$9,765 (-5.4%)	-\$13,020 (-7.2%)	-\$16,275 (-9.0%)
\$105,000 [30%]	\$208,691	-\$4,883 (-2.3%)	-\$9,765 (-4.7%)	-\$14,648 (-7.0%)	-\$19,530 (-9.4%)	-\$24,413 (-11.7%)
\$140,000 [40%]	\$235,553	-\$6,510 (-2.8%)	-\$13,020 (-5.5%)	-\$19,530 (-8.3%)	-\$26,040 (-11.1%)	-\$32,550 (-13.8%)
\$175,000 [50%]	\$262,416	-\$8,138 (-3.1%)	-\$16,275 (-6.2%)	-\$24,413 (-9.3%)	-\$32,550 (-12.4%)	-\$40,688 (-15.5%)

Source: Authors' own calculations from EVITA, 2013 SIH.

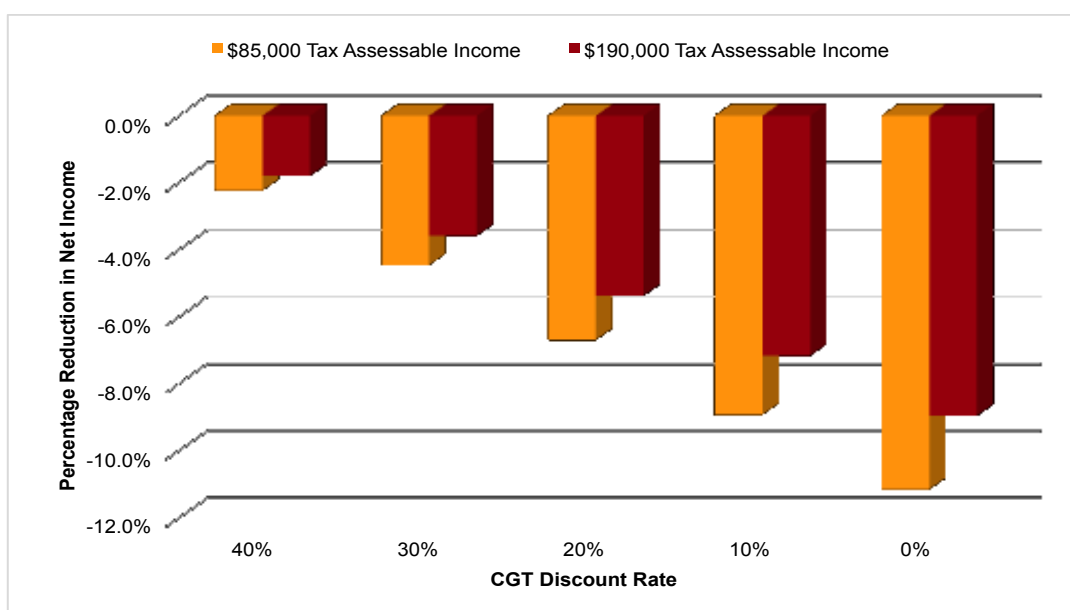
Figure 7 below highlights differences in impact that each CGT discount rate has on investors on two different levels of incomes. The figure holds the capital gains constant at \$70,000 and compares the impact on net income that is felt by a typical investor with \$85,000 and \$190,000 gross income. It is clear that a high-income investor will experience a greater dollar reduction in net income at each reformed CGT discount rate. However, in proportionate terms, the high-income investor experiences a smaller percentage reduction in net income (see Figure 8 below). Because of this discrepancy between percentage and dollar value impacts, any CGT policy reform proposals would need to be carefully communicated to avoid a misconception that the impact of the CGT reform is likely to be regressive in terms of its proportionate impact on rental investors' net incomes.

Figure 7: Impact of a reduction in CGT discount on the net income of a typical rental investor with gross annual income of \$85,000 and \$190,000, assuming capital gains of \$70,000, 2013, dollar reduction



Source: Authors' own calculations from EVITA, 2013 SIH.

Figure 8: Impact of a reduction in CGT discount on the net income of a typical rental investor with gross annual income of \$85,000 and \$190,000, assuming capital gains of \$70,000, 2013, percentage reduction



Source: Authors' own calculations from EVITA, 2013 SIH.

4.3.2 Impacts on the after-tax economic cost of supplying rental housing

As noted in the previous subsection, it is not possible to observe the sale of properties by rental investors that would in turn attract a CGT discount in the SIH. In this subsection we apply an alternative approach to analysing the impacts of CGT reforms on the economic outcomes of rental investors using AHURI-3M operationalised on the HILDA Survey. Because the sale of a property that attracts a CGT is a one-off transaction rather than a recurrent transaction, an

alternative approach of measuring the impact of CGT (and CGT reforms) on rental investors' economic outcomes is to amortise capital gains tax liabilities across the investor's holding period (Wood and Ong 2010, 2013; Wood, Ong et al. 2011).

AHURI-3M contains a rental investors' module operationalised on three of HILDA's wealth modules—in 2002, 2006 and 2010—that specifically measures the after-tax economic cost of supplying rental housing borne by rental investors, also commonly known as the user cost of capital. It is usually measured per dollar of capital value. The key components of the user cost typically comprise recurrent and capital components, with the latter amortised over a holding period of 10 years. The recurrent components include annual financing costs,⁹ annual operating costs¹⁰ and annual capital gains, while the amortised capital components include the amortised value of CGT liability and transaction costs. Details on measurement of the key components of the user cost are laid out in Wood and Ong (2008).

Table 14 below reports the after-tax economic cost born by landlords per dollar of the capital value of their rental property, for the years 2002, 2006 and 2010. On average, after-tax economic costs have been reasonably consistent across years, rising slightly from 6.7 per cent under actual CGT parameters to 7.3 per cent in 2006 and remaining more or less constant at 7.4 per cent in 2010. Taking an average residential rental investment property value of \$350,000, a user cost of 7.4 per cent in 2010 would amount to around \$25,900 in after-tax economic costs per year.

As in the previous subsection, the table documents the results of an investigation of a gradual reduction in CGT discount rate by ten percentage points to 0 per cent, which represents a complete abolition of the CGT discount. As the CGT discount is gradually reduced, this would increase landlords' after-tax economic cost of holding rental property in each year. Taking the year 2010, a complete abolition in CGT discount would increase rental investors' after-tax economic costs from 7.4 per cent to 8 per cent. However, a gradual reduction in the discount would 'soften' the impact of the CGT reform by providing a transition pathway that raises the after-tax economic cost of holding rental investment housing by 0.1 percentage point for every 10 percentage point reduction in the CGT discount rate. Assuming a rental investment property value of \$350,000, a 0.1 percentage point increase in user cost amounts to \$350 per year. The results support a case for a transitional approach in CGT reform, although it is worth noting that the approach of amortising CGT liabilities, while a convenient and logical approach in the absence of necessary data on sales transactions and capital gains, does not reflect the reality that the CGT tax is actually a lump sum liability rather than a recurrent annual expenditure.

⁹ The financing costs include after-tax interest on mortgage debt and the after-tax return sacrificed on the rental investor's equity stake in the property.

¹⁰ Operating costs include maintenance costs, property taxes and land taxes.

Table 14: Impact of a reduction in CGT discount on the average user cost rental investors, per cent of property value, 2002, 2006 and 2010

Year	User cost under CGT discount scenarios						% point difference between 0% discount and 50% discount
	Actual		Reforms				
	50%	40%	30%	20%	10%	0%	
2002	6.7%	6.9%	7.1%	7.2%	7.4%	7.6%	0.9%
2006	7.3%	7.5%	7.6%	7.7%	7.9%	8.0%	0.7%
2010	7.4%	7.5%	7.6%	7.8%	7.9%	8.0%	0.7%

Source: Authors' own calculations from AHURI-3M, 2002, 2006 and 2010 HILDA Survey.

In Table 15 below, we examine for the year 2010 the impact of different rates of capital gains. The AHURI-3M microsimulation model uses a baseline housing price appreciation rate of 3.5 per cent. We adopt this as a medium growth scenario, and compare it with a low growth scenario represented by an appreciation rate of 2.5 per cent and a high growth scenario represented by 4.5 per cent. Housing market conditions are clearly important; under the actual scenario, rental investors' after-tax economic costs of supplying rental housing rises falls from 8.8 per cent under a low growth scenario to 6 per cent under a high growth scenario. This is unsurprising as a higher capital appreciation rate will increase annual capital gains that are only partially offset by a discounted CGT liability.

Table 15: Impact of a reduction in CGT discount on the average user cost rental investors under different capital gains scenarios, per cent of property value, 2010

	House price appreciation rate	User cost under CGT discount scenarios					
		Actual		Reforms			
		50%	40%	30%	20%	10%	0%
<i>Mean user cost (%)</i>	2.50%	8.8%	8.9%	8.9%	9.0%	9.1%	9.2%
	3.50%	7.4%	7.5%	7.6%	7.8%	7.9%	8.0%
	4.50%	6.0%	6.2%	6.4%	6.6%	6.7%	6.9%
<i>% point diff. in user cost between reform and actual</i>	2.50%		0.1%	0.2%	0.3%	0.3%	0.4%
	3.50%		0.2%	0.3%	0.4%	0.5%	0.7%
	4.50%		0.2%	0.4%	0.5%	0.7%	0.9%

Source: Authors' own calculations from AHURI-3M, 2010 HILDA Survey.

Table 16 below sets out the predicted distributional impacts of the CGT reform across different income groups in 2010. Rental investors are classified according to their MITR bracket, with the lowest incomes reflected in the 0 per cent MITR bracket and investors on the highest incomes captured in the 45 per cent bracket. First, it can be noted that under the actual CGT scenario, the user cost declines as one progresses up the MITR bracket. This reflects the fact that landlords' tax savings from negative gearing and the CGT discount increase as their MITRs rise. Hence, the after tax-economic cost of holding property tends to be lower for rental investors on higher MITR brackets.

As noted in Chapter 1, the asymmetric tax treatment of rental income and capital gains favour high tax bracket investors at the expense of low tax bracket investors. These market imperfections create rent clientele effects, whereby rental submarkets with high expected capital

appreciation rates will attract high tax bracket investors because they pay lower taxes on capital gains than if they receive an equivalent sum in rental income. In contrast, in rental submarkets with low expected capital gains, high tax bracket investor demand will be weak, so property prices will fall. Low tax bracket investors will only invest in relatively low value rental housing that attracts rents that are high in relation to property values. This pushes up rents relative to property values in low value segments of the rental market, making rental housing more expensive and therefore less affordable in precisely those segments where lower income households typically seek housing (Wood and Tu 2004; Wood, Stewart et al. 2010).

A progressive reduction in the CGT discount rate will impact on rental investors on higher incomes to a greater degree than investors on lower incomes. So, for instance, as shown in Table 16 below, among those in the 0.1–5 per cent MITR track, a reduction in CGT discount rate from 50 per cent to 0 per cent would raise their average user cost of capital from 7.3 per cent to 8.1 per cent, a rise of 0.8 percentage points. However, among investors in the highest MITR tax bracket, average user cost of capital would rise by 1.2 per cent—from 7.4 per cent to 8.6 per cent. The results indicate that a reduction in CGT discount will narrow the gap in user cost burdens that lower income and higher income rental investors have to bear.

Table 16: Impact of a reduction in CGT discount on the average user cost rental investors, by pre-reform income unit MITR bracket, per cent of property value, 2010

	Pre-reform income unit MITR bracket	User cost under CGT discount scenarios					
		Actual		Reforms			
		50%	40%	30%	20%	10%	0%
<i>Mean user cost (%)</i>	0%	7.6%	7.6%	7.6%	7.6%	7.6%	7.6%
	0.1– 5%	7.3%	7.4%	7.5%	7.5%	7.6%	7.6%
	15.1–30%	7.4%	7.6%	7.7%	7.8%	7.9%	8.0%
	30.1–37%	7.3%	7.5%	7.7%	7.8%	8.0%	8.1%
	37.1–45%	7.4%	7.6%	7.8%	8.1%	8.3%	8.6%
	Total	7.4%	7.5%	7.6%	7.8%	7.9%	8.0%
<i>% point diff. in user cost between reform and actual</i>	0%		0.0%	0.0%	0.0%	0.0%	0.0%
	0.1–15%		0.1%	0.1%	0.2%	0.2%	0.3%
	15.1–30%		0.1%	0.3%	0.4%	0.5%	0.6%
	30.1–37%		0.2%	0.3%	0.5%	0.7%	0.8%
	37.1–45%		0.2%	0.5%	0.7%	0.9%	1.2%
	Total		0.2%	0.3%	0.4%	0.5%	0.7%

Source: Authors' own calculations from AHURI-3M, 2010 HILDA Survey.

4.4 Policy development implications

4.4.1 Negative gearing

Overall, the two negative gearing reforms that will result in the greatest amount of budgetary savings are a rental deduction cap of \$5,000 and progressive rental deductions on an income based criteria—both cost \$1.3 billion each, resulting in savings of over \$1.7 billion each. Both are progressive in nature, reducing tax savings from negative gearing by greater margins as tax assessable income increases.

If the policy concern is that a tightening of negative gearing parameters will impact on 'mum and dad' investors' economic wellbeing negatively and result in a behavioural decision by such investors to withdraw from the rental housing market, then it is likely that a progressive rental deduction that cushions 'mum and dad' investors from significant drops in tax savings will be a more appropriate policy option than a more blunt \$5,000 cap on rental deductions. The potential for significant housing supply contraction in the rental market may therefore be lower under a progressive rental deduction, holding all other factors constant.

Moreover, an income (property value) based deduction has the potential to reduce inequities inherent within the current systems by reducing tax savings by proportionately greater amounts for those who have relatively high income (property asset) levels than rental deduction caps.

However, it is noteworthy that progressive rental deduction reforms will likely be administratively more complex to implement than a cap. A more practical approach may be to differentiate between 'mum and dad' investors and 'sophisticated' investors by income or property value bands rather than percentile ranges.

Regardless of the income measure used to differentiate between the two types of investors, it is noteworthy that the progressive nature of the reform may blunt incentives to work by investors looking to reduce their incomes so they fall into a band or percentile that allows them to be classified as 'mum and dad' investors.

4.4.2 Capital gains tax discount

The greater the reduction in CGT discount rate and the higher the capital gains upon sale, the greater the reduction in net income for investors. Holding other factors constant, a higher income investor will also experience a greater dollar reduction in net income at each reformed CGT discount rate than a lower income investor with the same capital gains rate. However, in proportionate terms, the high-income investor experiences a smaller percentage reduction in net income. Because of this discrepancy between percentage and dollar value impacts, any CGT policy reform proposals would need to be carefully communicated to avoid a misconception that the impact of the CGT reform is likely to be regressive in terms of its proportionate impact on rental investors' net incomes.

A reduction in the CGT discount rate will impact on rental investors on higher incomes to a greater degree than investors on lower incomes. This will narrow the gap in user cost burdens that lower income and higher income rental investors have to bear, reducing inequities within the current system.

A gradual reduction in the discount would 'soften' the impact of the CGT reform by providing a transition pathway that raises the after-tax economic cost of holding rental investment housing by 0.1 percentage point for every 10 percentage point reduction in the CGT discount rate. Assuming a rental investment property value of \$350,000, a 0.1 percentage point increase in user cost amounts to \$350 per year. The results support a case for a transitional approach in CGT reform. However, it is worth noting the pros and cons of adopting an approach of amortising CGT liabilities. While it represents a convenient and logical approach in the absence of necessary data on sales transactions and capital gains, it does not reflect the reality that the CGT is actually a lump sum liability rather than a recurrent expenditure.

5 Policy development options

This report has developed and modelled pathways to reform the income tax treatment of housing assets. It focuses on key tax arrangements that have featured prominently in national policy debates as having the potential to exacerbate distortions in property markets, including negative gearing arrangements and CGT provisions.

The existing literature has highlighted concerns around the potentially distortionary effects of the present Federal income tax treatment of housing assets on housing market stability and housing affordability. Personal income tax concessions distort investment decisions, with adverse implications for the distribution of housing assets and outcomes in the housing market. First, the presence of debt financed housing investors on a large scale is a potential source of instability in the housing market. Second, it would appear that property investors are increasingly crowding out first home buyers from the property market. Third, the asymmetric tax treatment of rental income and capital gains favour high tax bracket investors at the expense of low tax bracket investors. Fourth, the main residence exemption, under which a primary residence is exempt from capital gains tax, can reduce mobility of labour supply. In short, personal income tax concessions distort investment decisions, with adverse implications for the distribution of housing assets and outcomes in the housing market. Despite periodic national reviews of the tax system such as the 2010 *Australia's Future Tax System* ('Henry' Review), meaningful action aimed at implementing reform to the negative gearing and CGT provisions continue to be fraught with political obstacles to change. These policy concerns form the primary motivators behind this report.

5.1 Key findings and links to policy development

5.1.1 How do existing elements of the Federal income tax system (in particular the availability of deductions and CGT provisions) potentially impact on housing ownership and affordability?

The Australian tax system is asymmetrical in respect of both owner-occupied and own-to-invest properties. Owner-occupied properties are exempt from many taxes, including capital gains tax. There is no imputed rent applied to claw back the exemption. In respect of own-to-invest properties, the report's policy audit has shown that the income tax treatment of investment property provides an annual tax deduction to the owners of negatively-gearred property that subsidises the holding cost of property. This deduction is made up of a combination of cash outgoings, of which the most significant is loan interest, and capital allowances which are non-cash expenses. In contrast, when the property is sold the gain is included on the capital account. The amount is included on realisation and is subject to a discount of 50 per cent when derived by an individual or a trustee, or 33 per cent when derived by a superannuation fund.

Hence, the policy audit identified two key sources of asymmetric treatment in rental income and capital gains in the housing market. First, there exists a mismatch in the timing of the deduction and the capital gain with the deductions predating the capital gain. Second, the amount of the rental deduction is not discounted whereas the capital gain is discounted. This combination of factors provides an incentive for the owners of investment properties to borrow a larger proportion of the acquisition price as the interest deduction is allowed in full whereas only 50 per cent of the capital gain is included. A leveraged investment will result in a higher capital gain where the growth in property prices exceeds the interest rate.

5.1.2 Which investor groups, household types and housing market segments benefit or are disadvantaged by current negative gearing and CGT provisions?

Negatively-gearred investors who receive the highest tax savings are typically middle-aged full-time employed males. On the other hand, the ones who benefit the least are females and older investors aged 55+ years who are not in the labour force. Home-owner investors who own both a family home and at least one rental investment property received the greatest CGT discount benefits while renters who do not own properties do not receive any CGT discount. CGT discount benefits are heavily weighted towards those who are more affluent in terms of both income and property wealth. On average, a home-owner investor can own a property portfolio worth over \$730,000. Home-owner investors' average tax assessable income is \$82,000 compared to \$31,000 among renters who do not own any properties.

A key policy consideration is that negative gearing and CGT discount benefits are heavily skewed towards those who are more affluent, raising issues around the extent to which such policies exacerbate income and wealth inequality among the Australian population. Negatively-gearred rental investors making a loss of around \$8,800 on average while positively-gearred investors make a profit of around \$16,000 on average. However, negatively-gearred investors have noticeably higher tax assessable incomes than positively-gearred investors. The former reported an average tax assessable income of \$91,000 in the 2013–14 SIH compared to \$78,500 among positively-gearred investors. Among negatively-gearred investors, those who receive the greatest tax savings are also those who have the highest incomes and rental property values, and greatest annual net rental losses. Similarly, CGT discount benefits are heavily weighted towards those who are more affluent in terms of both income and property wealth. On average, a home-owner investor can own a property portfolio worth over \$730,000. Home-owner investors' average tax assessable income is \$82,000 compared to \$31,000 among renters who do not own any properties. Hence, any reforms to negative gearing or CGT ought to ensure that it reduces inequities inherent within the current systems by reducing tax savings by proportionately greater amounts for those who have relatively high income or asset levels.

A second but tentative policy implication derives from the longitudinal analysis of rental investment spells in the HILDA Survey. It would appear that negatively-gearred investors may be more likely to terminate rental leases as market conditions change. Negatively-gearred investors make operating losses and hence their rental investment decisions are more sensitive to changes in economic conditions than positively-gearred investors, so this finding is not surprising. However, the policy implications are mixed. On the one hand, this may have adverse impacts on the tenure security of tenants and indeed overall housing market stability. On the other hand, as suggested by Wood and Ong (2010), there are potential efficiency gains from landlords having the flexibility to adjust supply in the rental market in response to changes in housing market conditions.

5.1.3 What are the revenue and distributional impacts of different negative gearing reform scenarios and transitional arrangements on housing investors and the Federal budget?

A complete abolition of negative gearing reforms has often been criticised by policy-makers for its potentially adverse impacts on the financial wellbeing of 'mum and dad' investors. Hence, in our first set of simulations, we distinguish between 'mum and dad' and 'sophisticated' investor and apply more generous concessions to the former. We differentiate between these investors groups in two ways—by applying income and property-based criteria.

Under the proposed reforms, 'mum and dad' investors in the bottom half of the income and property value distributions are excluded from any reduction in rental deductions and therefore experience no reduction in tax savings. At the other extreme, those in the upper quartile are

subject to a full quarantine of negative gearing and therefore receive zero rental deductions, resulting in a complete loss of their tax savings from negative gearing. Those in the 50th to 75th percentiles receive a 50 per cent rental deduction, a less severe measure than zero rental deductions. 'Mum and dad' investors in this group lose around half of their rental deductions. They are therefore cushioned from a complete loss of their rental deductions, and less likely to make a behavioural decision to exit the rental market than if they were subject to a full quarantining of negative gearing. Such a measure is therefore also a potential transitional arrangement that could ease the pathway towards a complete negative gearing quarantine for all rental investors over time.

If a rental deduction cap is applied across all income levels, the average tax savings that negative-geared rental investors receive reduces only very slightly by \$25 under a generous \$40,000 cap to a \$921 decline if the cap is further reduced to \$5,000. Reducing the cap levels will result in increasingly lower levels of rental deductions across the income distribution.

Overall, the two reforms that will result in the greatest amount of budgetary savings are a rental deduction cap of \$5,000 and progressive rental deductions on an income-based criteria—both cost \$1.3 billion each, resulting in savings of over \$1.7 billion each. Both are progressive in nature, reducing tax savings from negative gearing by greater margins as tax assessable income increases.

If the policy concern is that a tightening of negative gearing parameters will impact on 'mum and dad' investors' economic wellbeing negatively and result in a behavioural decision by such investors to withdraw from the rental housing market, then it is likely that a progressive rental deduction that cushions 'mum and dad' investors from significant drops in tax savings will be a more appropriate policy option than a more blunt \$5,000 cap on rental deductions. The potential for significant housing supply contraction in the rental market may therefore be lower under a progressive rental deduction, holding all other factors constant.

Moreover, an income (property value) based deduction has the potential to reduce inequities inherent with the current systems by reducing tax savings by proportionately greater amounts for those who have relatively high income (property asset) levels than rental deduction caps.

However, it is noteworthy that progressive rental deduction reforms will likely be administratively more complex to implement than a cap. A more practical approach may be to differentiate between 'mum and dad' investors and 'sophisticated' investors by income or property value bands rather than percentile ranges.

Regardless of the income measure used to differentiate between the two types of investors, it is noteworthy that the progressive nature of the reform may blunt incentives to work by investors looking to reduce their incomes so they fall into a band or percentile that allows them to be classified as 'mum and dad' investors.

5.1.4 What are the revenue and distributional impacts of different CGT reform scenarios and transitional arrangements on housing investors and the Federal budget?

It is possible to estimate the impact of a reduction in CGT discount rate on rental investors' economic outcomes in two alternative ways. The first approach is to estimate the impact of the CGT reform on rental investors' after-tax or net incomes at the point of sale. The second is to estimate the impact of the reform on a rental investor's after-tax economic costs of holding rental property (per dollar of the capital value of their rental property) by amortising the investor's CGT liability across the investor's property holding period.

In terms of net income impacts, a reduction in the CGT discount rate would reduce the net incomes of rental investors. However, the extent of this reduction will depend on interactions across various factors, including the discount rate reduction, the investor's income and the

investor's capital gains on the rental property at the time of sale. The greater the reduction in the CGT discount rate and the higher the capital gains upon sale, the greater the reduction in net income for investors. Holding other factors constant, a higher income investor will also experience a greater *dollar* reduction in net income at each reformed CGT discount rate than a lower income investor with the same capital gains rate. However, in *proportionate* terms, the high-income investor experiences a smaller percentage reduction in net income. Because of this discrepancy between percentage and dollar value impacts, any CGT policy reform proposals would need to be carefully communicated to avoid a misconception that the impact of the CGT reform is likely to be regressive in terms of its proportionate impact on rental investors' net incomes.

A reduction in the CGT discount rate will impact on rental investors on higher incomes to a greater degree than it will on investors on lower incomes. So, for instance, among those in the 0.1–15 per cent MITR band in 2010, a reduction in the CGT discount rate from 50 per cent to 0 per cent would raise their average user cost of capital from 7.3 per cent to 8.1 per cent, a rise of 0.8 percentage points. However, among investors in the highest MITR tax bracket, the average user cost of capital would rise by 1.2 per cent—from 7.4 per cent to 8.6 per cent. Hence, a reduction in CGT discount will narrow the gap in user cost burdens that lower income and higher income rental investors have to bear, reducing inequities within the current system.

A gradual reduction in the discount would 'soften' the impact of the CGT reform by providing a transition pathway that raises the after-tax economic cost of holding rental investment housing by 0.1 percentage point for every 10 percentage point reduction in the CGT discount rate. Assuming a rental investment property value of \$350,000, a 0.1 percentage point increase in user cost amounts to \$350 per year. The results support a case for a transitional approach in CGT reform, although it is worth noting that the approach of amortising CGT liabilities, while a convenient and logical approach in the absence of necessary data on sales transactions and capital gains, does not reflect the reality that the CGT tax is actually a lump sum liability rather than a recurrent annual expenditure.

5.2 Novel contributions and future research directions

This report confirms an existing body of knowledge about the distortionary impacts of negative gearing and CGT discount arrangements, and the potential of policy reforms to alleviate these distortions, with potential benefits for stability and reduction in inequity in the treatment of different lower income subgroups versus higher income subgroups in the housing market. However, it also offers new findings that are both novel and which add to the policy evidence base.

First, a sample validation exercise conducted across three nationally representative datasets—the ABS SIH, the HILDA Survey and the ATO sample file—shows that there is a significant underestimation of the number of negatively-g geared rental investors and net rental losses in the survey data. As part of this report's analysis, we have undertaken an intricate benchmarking exercise to redistribute net rental losses across rental investors in SIH, so that the distribution of net rental losses in the SIH are better aligned with the ATO data.

Second, this report has modelled several potential transitional arrangements that may ease the distribution pressures arising from reforms to negative gearing and CGT reform, and help smooth a reform pathway that is more politically acceptable. Importantly, a complete abolition of negative gearing reforms has often been criticised by policy-makers for its potentially adverse impacts on the financial wellbeing of 'mum and dad' investors. In a series of simulations, we distinguish between 'mum and dad' and 'sophisticated' investors and apply more generous concessions to the former so that they are less likely to make a behavioural decision to exit the rental market in response to a negative gearing reform that results in a reduction in rental

deductions. Such a measure is therefore also a potential transitional arrangement that could ease the pathway towards a complete negative gearing quarantine for all rental investors over time.

However, there remains scope for implementing an analysis that has the potential to further increase the evidence base to inform policy-making with regard to the Federal income tax treatment of housing assets.

First, there remains an under-reporting of net rental losses in the HILDA Survey that has not been addressed in this report. There is potential for future analysis to mitigate this reporting bias via replication of the SIH redistribution exercise across HILDA data.

Second, there remains scope for designing increasingly sophisticated modelling methodologies that would facilitate the modelling of combinations of negative gearing and CGT reform. Such modelling strategies would need to address at least two difficulties. One is that negative gearing affects a recurrent stream of income to rental investors, while the CGT is a lump sum liability that is levied at the point of sale of the property. Another is the fact that it is often not possible to observe the capital gain of properties and transactions that would result in the application of the CGT discount from survey data such as the SIH and HILDA Surveys.

Third, there appears to be potential in pursuing a progressive rental deduction reform that cushions the financial wellbeing of 'mum and dad' investors by applying more generous concessions to them than 'sophisticated' investors. While this report has presented results from two reforms based on income and property value criteria, there appears scope for experimenting with alternative criteria for differentiating between 'mum and dad' and 'sophisticated' investors.

Finally, the distributional analysis presented in this report has largely relied on individual income so there is scope to expand the analysis based on a household basis to take into account intra-household allocation of property investment assets should such data become available in the future.

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